Supreme Court, U.S.
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No.

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1998

DAVID M. DUREE,

Petitioner,

vs.

DOCTOR'S ASSOCIATES, INC.,

Respondent.

On Petition for a Writ of Certiorari
to the Supreme Court of Kansas

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. Whether an attorney's 14th Amendment due process rights to a fair and impartial trial before a fair and impartial judge were violated when the trial judge (who sanctioned the attorney in the sum of $408,445.25 and removed his authority to appear *pro hac vice*) admitted that she was unable to be fair and impartial as a result of a pre-decision *ex parte* conversation with another attorney from which she erroneously concluded that the attorney's client had a cocaine problem, the attorney knew about it and arranged for the preparation of an allegedly false income tax return to cover it up, where the trial judge also admitted that she was unable to separate this extrajudicial information and her erroneous conclusions from the merits of the claims against the attorney.

II. Whether an attorney's 14th Amendment due process rights to the probability and appearance of a fair trial before a fair tribunal were violated when the courts below concluded that the *ex parte* conversation by the trial judge (who sanctioned the attorney in the sum of $408,445.25 and removed his authority to appear *pro hac vice*) and the timing of her orders were "absolutely terrible in terms of eroding confidence in the independent exercise of judgment on the part of Judge Russell" and that the conduct of Judge Russell was "clearly inappropriate."

LIST OF PARTIES

Doctor's Associates, Inc., the Respondent, filed the motions at issue against Petitioner, David M. Duree. Mr. Duree's clients were defendants Nancy Kessler and Dane Banks. Subway Restaurants, Inc. and Subway Equipment Leasing Corp. were plaintiffs in the case below and Doctor's Associates, Inc. was a plaintiff and counterclaim defendant. Doctor's Associates, Inc. does business through numerous affiliated companies, including, but not limited to, Subway Sandwich Shops, Inc., Subway Real Estate Corp., Franchise World Headquarters, Inc., Subway Central, Inc., Subway East, Inc., Subway West, Inc. and many others. Frederick DeLuca and Peter H. Buck are the owners of Doctor's Associates, Inc. and most of its affiliated companies. Nancy Kessler and Dane Banks did business in 1989 and 1990 in the form of a partnership known as Subway Ltd.

There are no parent or other subsidiary companies of any party that are required to be listed.

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DAVID M. DUREE,

Petitioner,

vs.

DOCTOR'S ASSOCIATES, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI

Petitioner, David M. Duree, respectfully petitions for a Writ of Certiorari to review the judgment entered by the Supreme Court of Kansas on December 18, 1998.

OPINION BELOW

The opinion below was issued on December 18, 1998 and is reproduced in the Appendix at pages 80a through 106a. It is reported at 970 P.2d 526 (Kan. 1998).

STATEMENT OF JURISDICTION

The Kansas Supreme Court entered judgment on December 18, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

STATUTES INVOLVED

14th Amendment of the United States Constitution.

Section 1. * * * nor shall any state deprive any person of life, liberty, or property, without due process of law; * * *.

STATEMENT OF THE CASE

Doctor's Associates, Inc. ("DAI") is the national franchisor for Subway sandwich shops. Nancy Kessler and Dane Banks ("Kessler & Banks") operated a Subway sandwich shop, pursuant to a franchise agreement with DAI, in Olathe, Kansas during 1989 and 1990.

DAI and its affiliated leasing companies, Subway Restaurants, Inc. and Subway Equipment Leasing Corp., brought suit against Kessler & Banks in 1990, alleging breach of the franchise agreement and real estate and equipment leases, seeking monetary damages and eviction. Kessler & Banks filed a counterclaim against DAI alleging fraud.

During 1991 David M. Duree (Petitioner) and Robert L. Carter entered their appearance as attorneys for Kessler & Banks. Su Linda Jamison

entered her appearance shortly thereafter as local counsel for Kessler & Banks.

Discovery was completed by the fall of 1994 and Kessler & Banks filed their pre-trial questionnaire listing the exhibits and witnesses they proposed to use at trial. They did not include any tax returns among their 100 exhibits. All matters were concluded except for dispositive motions and the trial.

In 1995 DAI filed a massive summary judgment motion on Kessler & Banks' counterclaim for fraud, listing 267 paragraphs of alleged uncontested facts, accompanied by a 99-page brief.

Robert L. Carter prepared the response to the statement of uncontested facts and the brief in opposition on behalf of Kessler & Banks. The response and brief in opposition were signed by Robert L. Carter and Su Linda Jamison. Mr. Duree neither prepared, signed nor filed the response or the brief in opposition.

Only two paragraphs of DAI's 267-paragraph statement referred to the original 1989 tax return; fact statements 143 and 159. The response and the brief in opposition denied fact statements 143 and 159 on the basis of Robert Seiffert's affidavit. Robert Seiffert is the expert witness, CPA, retained on behalf of Kessler and Banks. His April 1, 1995 affidavit (prepared and filed by Robert L. Carter and Su Linda Jamison) denied fact statements 143 and 159 because an amended 1989 tax return had been prepared.

Mr. Duree did not prepare, sign or file any of these pleadings on behalf of Kessler and Banks. The trial court subsequently found that the attorneys who did, Robert L. Carter and Su Linda Jamison, were "not culpable." 42a, 53a.

Kessler & Banks did not file a copy of the amended 1989 partnership tax return ("the amended return") with the court in opposition to the summary judgment motion. DAI's attorney handed a copy to the court during the April 13, 1995 oral argument on the summary judgment motion.

On April 12, 1995, Robert L. Carter prepared and filed a motion for sanctions against DAI's attorneys, contending that the 267 paragraphs of alleged uncontested facts and 99-page brief in support contained many immaterial matters and claimed as undisputed, facts which were actually disputed. It made no specific reference to the amended tax return. A copy was faxed to the attorneys for DAI on April 12, 1995.

Mr. Duree did not prepare, sign or file that motion for sanctions.

Mr. Duree argued against DAI's motion for summary judgment on Kessler & Banks' counterclaim for fraud the following day, April 13, 1995. He did not oppose the summary judgment on the basis of the amended tax return. The attorney for DAI argued against the April 12, 1995 motion for sanctions, although it was not on the docket, contending it was unfair to ask for sanctions against him for not referring to the amended tax return in his summary

judgment pleadings because the amended 1989 return he received in discovery, during January, 1993, was not signed, and he did not know whether it had ever been filed with the Internal Revenue Service. The Kansas Supreme Court later ruled that but for the motion for sanctions the issue about the amended tax return would probably never have arisen. 101a-102a.

During the April 13, 1995 summary judgment hearing, Judge Russell asked Mr. Duree whether the amended 1989 tax return had been signed and filed. Mr. Duree responded, accurately, that the amended tax return was an evidentiary detail which was not outcome determinative on the summary judgment motion and that he did not know, without double-checking, whether it had been signed and filed. Judge Russell commented at that time, and the Kansas Supreme Court later found, that it greatly disturbed her that an attorney would question the ethics of DAI's attorney with respect to the amended tax return without knowing whether it had been signed or filed. 86a, 101a, 102a. At the time the motion for sanctions was not scheduled for hearing (it had been filed on the previous day), it did not specifically refer to either the original or amended 1989 tax return, and it had not been prepared, signed or filed by Mr. Duree.

Subsequently it was established that the amended tax return had been signed and filed with the Internal Revenue Service at the time it was produced to DAI in discovery, during January, 1993. 38a. It has never been challenged by the Internal Revenue Service.

On June 9, 1995, Judge Russell granted DAI's motion for summary judgment on the counterclaim for fraud, ruling that fact statement Nos. 143 and 159, while disputed, were not material. 5a.

DAI then moved for and obtained an order permitting discovery to determine whether the amended return had been signed and filed with the Internal Revenue Service. Once it was established that the amended tax return had been signed and filed with the Internal Revenue Service, 38a, DAI filed motions against Mr. Duree for sanctions and to remove his authority to practice *pro hac vice*, claiming that he had proffered a false document, the amended return, to the court

Mr. Duree had not filed the amended 1989 tax return with the court. He had not prepared, signed or filed the pleadings opposing summary judgment, which briefly referred to the amended return with respect to fact statement Nos. 143 and 159, on the basis of the attached April 1, 1995 affidavit of Robert Seiffert. Mr. Duree also did not prepare or file Mr. Seiffert's April 1, 1995 affidavit. During oral argument on the summary judgment motion, Mr. Duree did not argue the amended tax return as a basis for denying summary judgment. His only discussion about the amended tax return was to state that it was an evidentiary detail which was not outcome determinative and that he did not know, without double-checking, whether it had been signed and filed with the Internal Revenue Service. The summary judgment motion was based, primarily, upon DAI's claim that Kessler and Banks' financial

records were so poor that they could not prove that their admitted losses were caused by any fraud by DAI. Causation was the summary judgment issue. 6a, 71, 11a - 15a. Neither the fact nor the amount of damages were the issue.

Summary judgment was entered because Kessler and Banks' financial records were so poor they could not prove their losses were caused by DAI's fraud. Kessler and Banks argued that they could prove causation. While granting summary judgment on the issue of causation, 6a, 7a, 11a-15a, Judge Russell ruled that the two paragraphs about tax returns, fact statements 143 and 159, were not material. 5a.

Robert Seiffert's April, 1995 affidavit and damage schedule calculated Kessler and Banks' total damages at $255,257.00. His damage calculations were based upon out-of-pocket losses based primarily upon the value of Kessler and Banks' assets before they began operations, the fact that they lost everything during their 18 months of operations, and the amount of additional indebtedness they incurred during operations. Kessler and Banks did not claim lost profits.

Kessler and Banks filed an original 1989 partnership tax return with the Internal Revenue service, during 1990, reflecting taxable income of about $20,000.00. Kessler and Banks, and Robert Seiffert after his initial review of the records, advised Mr. Duree, the lead attorney for Kessler and Banks, that they had actually lost money during 1989 (and 1990), and that the original tax return was

inaccurate. Mr. Duree made the decision to file an amended tax return for 1989, and to file tax returns for 1990, a year in which Kessler and Banks had not filed returns, for the trial strategy purposes of diffusing cross-examination of Robert Seiffert, on the basis of the original return, and to diffuse cross-examination of Kessler and Banks because they had not filed returns for the following year. He did not instruct Robert Seiffert to prepare a false return for 1989 or any other year.

Because the financial records of Kessler and Banks were so poor, Mr. Seiffert prepared an amended 1989 tax return using their bank deposits for receipts and their canceled checks for expenses. Mr. Seiffert interviewed Kessler and Banks, learning that they had paid employees and vendors with cash, they did not know the source of the numbers they provided to H&R Block for the original tax return, they admitted that their ledgers were inaccurate, that they did not have complete records of their expenses and that they had documented deductions which were not included in the original 1989 return. Mr. Seiffert also relied upon the fact that they lost all of their assets during the 18 months of operation, and his prior experience in other Subway cases, which established that the gross receipts of about $3,500.00 per week reflected by the weekly informational sales reports (WISR's) would not provide a profit for the average Subway store. Mr. Seiffert then determined to use only the bank records in preparing the amended tax return, both for purposes of determining receipts, by bank deposits, and expenses, deducting only expenses paid by cancelled check. A disclaimer was added to the return. The amended return

reflected a loss of $17,000.00. The difference between the original tax return, income of $20,000.00, and the amended tax return, a loss of $17,000.00, totals $37,000.00, a small portion of Kessler and Banks' total claimed damages of $255,257.00.

During the hearings on the motions for sanctions against Mr. Duree and for removal of his authority to practice *pro hac vice*, DAI claimed the amended tax return was a false document because it failed to report all the gross receipts reflected on the WISR's. DAI did not claim, or attempt to prove, that the amended tax return inaccurately reported Kessler and Banks' taxable income (or loss). DAI attached the affidavit of Ned Allen Ford to its motions against Mr. Duree. Mr. Ford was deposed. He admitted that he was not a CPA (he is a professor), he failed the CPA exam the only time he took it, he is not authorized to appear before the Internal Revenue Service on behalf of taxpayers, he did not review any of the books and records of Kessler and Banks, he made no effort to determine whether the amended 1989 tax return accurately reported the taxable income (loss) of Kessler and Banks, and he was not asked to make that determination. He also made no determination about whether the original tax return, prepared by H&R Block, correctly reported Kessler and Banks' taxable income for 1989. DAI did not call Mr. Ford as a witness.

DAI also retained Geoffrey Hazard as an expert witness. He is an attorney who regularly testifies about attorney conduct, the rules of conduct, and related matters. He is not an expert in accounting or

tax matters. He earns about $400,000.00 a year, using about 20% of his time, doing this kind of work. He spent about two or three hours reviewing materials about Mr. Duree before executing his affidavit (attached to DAI's motions). He charged $6,750.00. For work beyond that, he charged $500.00 an hour for work in the office and $700.00 an hour for trial time. He admitted that he had no personal knowledge of the statements about Mr. Duree set forth in his affidavit. He also acknowledged that he did not determine, and had not been asked to determine, whether the original 1989 tax return accurately reported taxable income or whether the amended 1989 tax return accurately reported taxable income (or loss).

Mr. Hazard gave his opinion that the amended tax return was a false document even if it correctly reported the amount of Kessler and Banks' taxable income for 1989.

Robert Seiffert testified, in his December 16, 1995 affidavit, that the amended return correctly, even conservatively, stated a loss of $17,000.00, that the gross receipts method used in preparing the original return resulted in an inaccurate statement of taxable income because it failed to include all of Kessler and Banks' deductible expenses, and that the bank account method he employed in preparing the amended tax return was the best method under these circumstances to arrive at the taxable income of Kessler and Banks for 1989.

Joe Marchbein is a CPA who spent 25 years with the Internal Revenue Service. He is employed

by the same firm as Robert Seiffert, Rubin, Brown & Gornstein, a respected accounting firm in St. Louis, Missouri. The amended tax return was signed by Mahlon Rubin, the founder of Rubin, Brown & Gornstein, although it was prepared by Robert Seiffert. Both Robert Seiffert and Joe Marchbein offered their opinion that the method employed by Mr. Seiffert was appropriate and that he exercised due diligence in preparing the amended 1989 tax return.

DAI offered no evidence to the contrary, but argued that the amended tax return was a false document because it misstated gross receipts, irrespective of whether it accurately determined tax liability.

DAI's cross examination of Mr. Duree demonstrates its position:

> Q. * * * Isn't it true that one of the arguments that you are making to Judge Russell is that false, not false, knowing, not knowing, it really doesn't make any difference, Your Honor, this is an alternative argument – if I'm hearing you right – because none of this is material. Haven't you said that two or three times this morning already.
>
> A. What I have said, and what I argued to the Court, is your alleged misstatement about the gross receipts doesn't have any outcome, doesn't have any effect on the outcome of this case, unless you can

> show that that statement results in a misstatement of taxable income for 1989 or profit or loss for 1989, which you have not done and you've not attempted to do.
>
> Q. Well, Mr. Duree, fortunately, from my perspective, we don't have to get to that point about income or loss because Judge Russell granted summary judgment; correct? * * *

The summary judgment determined only that the original and amended 1989 tax returns were immaterial - - it did not determine whether either 1989 tax return correctly reported taxable income (or loss). 5a.

During closing argument on the motions against Mr. Duree, DAI argued that it was undisputed that Kessler and Banks lost money during the 18 months they operated their Subway store and that it was not required to prove that the original 1989 tax return accurately stated Kessler and Banks' taxable income. The financial records for Kessler and Banks were just as poor for purposes of preparing the original 1989 tax return as for preparation of the amended 1989 tax return.

Robert Seiffert confirmed that he had not discussed the method of preparing the amended tax return with David Duree, and that David Duree had exercised no influence over him in determining the method of calculating the taxable income for 1989 or the method of preparing the amended tax return.

Mr. Duree testified, accurately, that he had never read the amended tax return, and did not know its contents or method of preparation or the alleged falsity in the amended tax return until after DAI filed its current motions for sanctions and for removal of his authority to practice in the Kansas case *pro hac vice*, during October and November, 1995.

There was no evidence to the contrary. DAI asked Judge Russell to infer that David M. Duree had knowledge of the alleged falsity of the tax return because he was lead counsel for Kessler and Banks and because he made the decision that an amended tax return should be filed.

The Kansas Supreme Court sidestepped the question of whether DAI was required to prove that Mr. Duree had actual knowledge of the alleged falsity of the amended 1989 tax return. 102a. The Kansas Supreme Court concluded, however, that the 1989 amended tax return was "evidence of Duree's misconduct." 103a. Neither DAI nor any of the Kansas courts ever explained how the amended tax return could be evidence of Mr. Duree's alleged misconduct where there was no evidence that he ever read it or was aware of its contents at any relevant time. He neither prepared, filed nor signed the pleadings opposing summary judgment which briefly referred to the amended tax return and he did not argue against the summary judgment motion on the basis of the amended tax return. The only things that Mr. Duree ever said about the amended tax return is that he never read it (at any relevant time), he did not know the method of its preparation, it was an

evidentiary detail which was not outcome determinative on the summary judgment motion and he did not know, without double-checking, whether it had been signed and filed with the Internal Revenue Service.

On May 31, 1996, Judge Russell entered a memorandum opinion assessing sanctions against Mr. Duree in the sum of $408,445.25 and removing his authority to practice in the Kansas case *pro hac vice*. Judge Russell concluded that Mr. Duree deliberately caused the preparation of a false tax return for use in that litigation. She concluded further that "but for the false return, their [Kessler and Banks'] fraud claim could not have been filed." 43a. Neither DAI nor the Kansas courts ever explained how the amended 1989 tax return was transformed from "immaterial" to the summary judgment motion, and therefore the fraud counterclaim, on June 9, 1995, when summary judgment was granted, to "but for" the amended 1989 return, the fraud counterclaim could not have been filed, on May 31, 1996, less than one year later. Compare 5a with 43a.

On May 31, 1996, Judge Russell found that Mr. Duree vehemently argued that DAI's summary judgment motion argument was frivolous (on April 13, 1995) on the basis of the amended 1989 tax return and, on the same basis, that DAI's attorney should be sanctioned as a result. 38a. Mr. Duree never argued against the summary judgment motion on the basis of the amended 1989 tax return and never argued the April 12, 1995 motion for sanctions against DAI's attorneys on any grounds. The motion for sanctions

was withdrawn after the April 13, 1995 oral argument on summary judgment. These "findings" by Judge Russell on May 31, 1996 were omitted from the formal judgment (journal entry) prepared by DAI. Compare 38a with 48a-54a.

The May 31, 1996 memorandum opinion made no finding that the counterclaim for fraud had been prosecuted in bad faith, but awarded sanctions solely on the grounds that "but for" the amended 1989 tax return, the counterclaim for fraud could not have been filed. 43a.

The May 31, 1996 memorandum opinion directed the attorneys for DAI to prepare a journal entry. 43a. DAI then prepared a proposed journal entry which included numerous findings that the amended counterclaim for fraud had been prosecuted in bad faith. These findings were not contained within the May 31, 1996 memorandum opinion. Compare 36a-43a with 48a-54a. The underlined material in the July 19, 1996 journal entry, drafted by DAI, was not contained within the May 31, 1996 memorandum opinion. 50a-54a. It was these findings [by DAI] that the Kansas Supreme Court eventually affirmed. 98a, 99a, 100a.

During the July 19, 1996 hearing DAI argued that the proposed journal entry varied from the memorandum opinion because Mr. Duree was in danger of losing his license to practice law, 45a, as a result of Judge Russell's prior ruling, and DAI was simply attempting to "make sure that this record is buttoned up as tightly as possible to give Mr. Duree as little room as possible to go through the

machinations we can all predict he will go through before the court of appeals." 45a, 46a. Judge Russell stated that she did not see anything in the journal entry that was not included in her memorandum opinion. 46a. Compare 36a-43a with 48a-54a. During the subsequent evidentiary hearing of July 8, 1997, Judge Russell testified that if the underlined material in the journal entry was not contained within her memorandum opinion [it is not], the journal entry reflected a substantial change from her memorandum opinion. 67a, 68a. Judge Russell testified further, however, that if the statements in the journal entry drafted by DAI were not contained within her memorandum opinion, DAI's statements were what she meant. 68a, 69a. Eight weeks after the *ex parte* conversation, Judge Russell delegated the court's fact finding responsibility to DAI.

The additional findings in the July 19, 1996 journal entry were not already in Judge Russell's word processor at the time of the *ex parte* conversation on May 24, 1996 (or earlier). Those additional statements do not fall within Judge Russell's suggestion that she had already made her rulings at the time of the *ex parte* conversation. 58a. Judge Russell also testified that she did not have a clear memory of the July 19, 1996 hearing to resolve the disputes over the journal entry. 66a.

On November 8, 1996 Judge Russell announced that she was unable to hear Mr. Duree's post-judgment motion because of the *ex parte* conversation and the conclusions she had drawn from the conversation. 63a, 64a. Judge Russell could not

separate this extrajudicial information from the issues concerning Mr. Duree and recused herself (on November 8, 1996) because she was unable to be fair and impartial. 64a, 65a. She subsequently revealed that this conversation had occurred on May 24, 1996, one week before her memorandum opinion was issued, although she stated that a draft of her memorandum opinion had already been prepared. 58a. Mr. Gerstle believed the *ex parte* conversation occurred during 1995, but he could not be certain. Judge Russell appointed Judge Sheppard to replace her on November 8, 1996. Judge Sheppard subsequently ruled that Mr. Gerstle's initial statement, that the *ex parte* conversation occurred in 1995, is probably the most credible recollection (of Mr. Gerstle). 78a.

Judge Russell also believed Nancy Kessler was taking money from the cash register to support a drug habit when she granted summary judgment on June 9, 1995 – although, Judge Russell contended, that did not affect her decision. 56a-57a. John Gerstle had represented Nancy Kessler on a charge of forging small checks. When Judge Russell found out about that representation, during the *ex parte* conversation, she asked, "Cocaine?" and he responded, "Oh, yeah. Big time." 59a. From this *ex parte* conversation, Judge Russell concluded, at that time, that Mr. Duree knew about Nancy Kessler's cocaine habit, knew she was taking money out of the business to support her habit, that this was the reason for filing the amended tax return, and that Mr. Duree hired Mr. Gerstle to cover this up, all of which caused her to be unable to be fair and impartial toward Mr.

Duree. 60a-64a. Judge Russell could not set that conversation with John Gerstle out of her mind and found it to be impossible to separate the conversation from the issues she was called on to decide on that day, apparently referring to November 8, 1996. 65a. She also testified that the conditions which caused her to be unable to be fair and impartial, and unable to separate the extrajudicial information from the issues before her, also existed on July 19, 1996 when the journal entry (formal judgment) was entered and on May 31, 1996 when her memorandum opinion was issued. 65a.

Judge Russell testified further that the *ex parte* conversation caused her to conclude there was a relationship between Nancy Kessler's cocaine use and the amended tax return. She concluded that Mr. Duree knew about Nancy Kessler's drug problems, knew that was why money was being taken out of the cash register, and the amended tax return was prepared to make it more difficult to discern Nancy Kessler's drug use. 61a. After Judge Russell was prompted by her pre-hearing deposition, she acknowledged that the *ex parte* conversation caused her to conclude that the decision to file the amended tax return was tied to Mr. Duree's knowledge of Nancy Kessler's cocaine problem, 62a, and that Mr. Duree hired Mr. Gerstle to cover up or get rid of the cocaine problem for Nancy Kessler. 63a.

None of this is true, and there was no evidence to support any of these conclusions. Judge Russell's testimony also casts doubt upon her ability to draw inferences from circumstantial evidence. No one has

ever explained how the filing of an amended 1989 tax return during January, 1993 could conceal Nancy Kessler's alleged cocaine use.

Upon recusing herself from hearing the post-judgment motion, on November 8, 1996, Judge Russell appointed Judge Sheppard as her successor. He ruled on the original post-trial motion on January 17, 1997, concluding it was not his responsibility to review Judge Russell's May 31, 1996 memorandum opinion and July 19, 1996 journal entry. 54a, 55a. As a consequence, the May 31, 1996 memorandum opinion and the July 19, 1996 journal entry were never reviewed on the merits at the trial level. The subsequent appellate review by the Kansas Supreme Court was on a deferential, abuse of discretion, standard. 93a.

Judge Sheppard was also extremely deferential to Judge Russell in ruling on the second post-trial motion based upon Judge Russell's admitted inability to be fair and impartial toward Mr. Duree. On July 8, 1997, he repeated his prior (January 17, 1997) position (that it was not his responsibility to review Judge Russell's rulings), stated that Judge Russell had lived with this case for 5 years, 75a, then held that a "reasonable person" would have concluded that she had entered her previous rulings without bias and without prejudice. 79a.

Finally, Judge Sheppard ruled that the timing of the *ex parte* conversation (on or before May 24, 1996) and the issuance of Judge Russell's memorandum opinion a week or more later, on

May 31, 1996 "was absolutely terrible in terms of eroding confidence in the independent exercise of judgment on the part of Judge Russell."

In addressing the constitutional due process issue, the Kansas Supreme Court stated "throughout his brief, Duree misstates the record and misconstrues Judge Russell's testimony about the *ex parte* conversation. Judge Russell admitted neither an inability to be fair and impartial nor an inability to separate extrajudicial knowledge from the issue of whether to award the sanctions. Judge Russell recused herself because she did not want to decide the motion to alter or amend the sanctions award." 94a. Judge Russell testified, however, "and the basis for your decision that you made on November the 8th that you couldn't be impartial was the conclusion that you reached back at the time of this discussion with Mr. Gerstle that David Duree knew about Nancy Kessler's cocaine habit, he knew she was taking money out of the business to support her habit, that that was part of the basis for her deciding to amend the '89 tax return, and that his basis for hiring Mr. Gerstle was to cover this up. All of these facts caused you to feel you couldn't be an impartial hearer of the facts, if you will; isn't that true? A. Yes. Q. Okay. A. I could not set that conversation with John Gerstle out of my mind. I found it impossible to separate that from the issues that I was called upon to decide on that day, and I therefore thought it was appropriate for me to recuse myself." 64a-65a.

She then confirmed that the same circumstances that caused her to be unable to be fair

and impartial and unable to separate extrajudicial information from the issues before her that existed on November 8, 1996 also existed on July 19, 1996 and May 31, 1996. 65a.

REASONS FOR GRANTING THE WRIT

I. The Petition should be granted because the judgment of the Kansas Supreme Court conflicts with prior decisions of this Court holding that the due process clause of the 14th Amendment requires a fair trial before a fair and impartial judge.

The Fourteenth Amendment's due process clause requires a fair trial before a fair tribunal which requires an absence of actual bias that includes even the probability of unfairness. In re Murchison, 349 U.S. 133, 136 (1955), accord, Withrow v. Larkin, 421 U.S. 35, 46, 47 (1975). "Every procedure which would offer a possible temptation to the average man as judge...not to hold the balance nice, clear and true between the state and the accused, denies the latter due process of law." 349 U.S. 133, 136, citing Tumey v. Ohio, 273 U.S. 510, 532 (1927). Application of the fair trial and a fair tribunal rule may sometimes bar trial by judges who have no actual bias and who would do their very best to weigh the scales of justice equally between contending parties, because to perform the Court's high function in the best way "justice must satisfy the appearance of justice." In re Murchison, 349 U.S. 133, 136 (1955), citing Offutt v. United States, 348 U.S. 11, 14 (1954).

While most questions concerning a judge's qualifications are answered by common law, statute, or the professional standards of the bench and bar, the floor established by the due process clause clearly requires a "fair trial and a fair tribunal," Withrow v. Larkin, 421 U.S. 35, 46, 47, (1975), "before a judge with no actual bias against the defendant or interest in the outcome of his particular case." Bracy v. Gramley, ___ U.S. ____, 117 S.Ct. 1793, 1797 (1997). The Kansas Supreme Court rejected Mr. Duree's argument that Judge Russell was required to recuse herself before entering the May 31, 1996 memorandum opinion and July 19, 1996 journal entry under the Kansas Code of Judicial Conduct, Rule 601A Canon 3E1 (1998 Kan. Ct. R. Annot. 455) after ruling that, under the Kansas standard, a judge has a duty to recuse when her impartiality might reasonably be questioned. 94a-95a. The Kansas Supreme Court reviewed Judge Sheppard's July 8, 1997 ruling on this issue, 79a, on an abuse of discretion standard. 93a. While acknowledging the "impartiality might reasonably be questioned" standard, the Kansas Supreme Court, and Judge Sheppard, actually applied an "actual bias and prejudice" standard, since both courts ruled that Judge Russell's rulings were "absolutely terrible in terms of eroding confidence in the independent exercise of judgment on the part of Judge Russell." 78a, 105a, 106a. Judge Sheppard held it was not his responsibility to review Judge Russell's May 31, 1996 and July 19, 1996 rulings, 54a, 55a. In ruling on Mr. Duree's motion based upon Judge Russell's admitted inability to be fair and impartial, Judge Sheppard was again extremely deferential to Judge Russell. 75a, 78a, 79a. He determined that a reasonable

person would conclude that Judge Russell acted without bias and without prejudice, 78a, 79a, while also ruling that the timing of the *ex parte* conversation and Judge Russell's rulings were "absolutely terrible in terms of eroding confidence in the independent exercise of judgment on the part of Judge Russell." 78a.

It is not the responsibility of this Court, however, to review the Kansas Supreme Court's application of the Kansas rule which compares with 28 U.S.C. §455.

The issue before this Court is whether the Kansas Courts afforded Mr. Duree due process of law by providing him with a fair trial before a fair tribunal, which includes the prevention of the probability of unfairness and the appearance of justice.

The Kansas Supreme Court also stated: "Duree misstates the record and misconstrues Judge Russell's testimony about the *ex parte* conversation. Judge Russell admitted neither an inability to be unfair and impartial nor an inability to separate extrajudicial knowledge from the issue of whether to award the sanctions. Judge Russell recused herself because she did not want to decide the motion to alter or amend the sanctions award." 94a.

This Court is not bound by these conclusionary "findings" by the Kansas Supreme Court. There is a distinction between giving great weight to the findings of fact of the lower courts on subordinate

facts and the weight to be afforded the conclusions of the lower court which may imply a standard of law on which the judgment rests. Offutt v. United States, 348 U.S. 11, 15 (1954). Baumgartner v. United States, 322 U.S. 665, 670-671 (1944). Moreover, the quoted statement by the Kansas Supreme Court merely inaccurately describes the unequivocal testimony of Judge Russell that she was unable to be fair and impartial and could not separate her extrajudicial information from the merits of the claims against Mr. Duree.

Judge Russell unequivocally testified that she had harbored suspicions that Nancy Kessler had a cocaine problem even when she granted DAI's summary judgment motion on June 9, 1995, 59a, and that her May 24, 1996 (or earlier) conversation with John Gerstle caused her to conclude "at that point in time, May 24" that Nancy Kessler was John Gerstle's client on a drug charge (that was erroneous), that Mr. Duree knew about Nancy Kessler's drug problem (that was erroneous), that Mr. Duree knew that Nancy Kessler was taking money from the till to support her drug habit (that was erroneous), and that there was a relationship between Nancy Kessler's drug use and Mr. Duree's decision to arrange for preparation of an amended 1989 tax return (that was erroneous). 60a, 61a, 62a, 63a. She also testified that the conclusions she reached "back at the time of this discussion with Mr. Gerstle, that David Duree knew about Nancy Kessler's cocaine habit," caused her to be unable to be fair and impartial. 64a. She testified that the conditions which caused her to be unable to be fair and impartial, and which made it impossible

for her to separate the issues before her from the *ex parte* conversation and the conclusions she drew from that conversation, existed on November 8, 1996 when she recused herself, on July 19, 1996 when she entered the journal entry, and on May 31, 1996 when she issued her original memorandum opinion. 64a, 65a.

Judge Russell's rulings also establish that she was clearly influenced, improperly, by the *ex parte* conversation and the conclusions that she erroneously drew from that conversation.

In granting the summary judgment motion of DAI on June 9, 1995, Judge Russell ruled that the statements of fact about the amended return were immaterial. 5a. Less than one year later, Judge Russell ruled that "but for" the (alleged) false tax return, Kessler and Banks' fraud counterclaim could not have been filed. 43a. The transformation from "immaterial" to "but for" status can only be explained by reference to the improper *ex parte* conversation and the erroneous, obviously prejudicial, conclusions Judge Russell drew from the conversation.

Moreover, Judge Russell presided over the hearing to resolve the dispute about the journal entry (formal judgment) on July 19, 1996, at least eight weeks after the *ex parte* conversation. DAI drafted the journal entry. Mr. Duree objected that it went far beyond Judge Russell's May 31, 1996 memorandum opinion. Judge Russell signed DAI's journal entry which contained many findings that the amended counterclaim for fraud was prosecuted in bad faith,

that were not contained within her original May 31, 1996 memorandum opinion. The materials included in the journal entry which are not contained within the memorandum opinion are underlined. 50a-53a. It is these findings that the Supreme Court affirmed after a deferential review of Judge Russell's and Judge Sheppard's rulings. 96a, 105a.

Judge Russell's extrajudicial information, her erroneous conclusions drawn therefrom and her subsequent transformation of the amended tax return from "immaterial" to "but for" status clearly established bias and prejudice of the kind prohibited by the due process clause. See Liteky v. United States, 510 U.S. 540, 551 (1994) for a definition of bias and prejudice which can require recusal under 28 U.S.C. §455 even when drawn from judicial as opposed to extrajudicial sources.

Mr. Duree has many good faith defenses to the charges against him, including: (1) the amended 1989 tax return is not a false document; (2) Mr. Duree neither tendered the amended return to the court nor argued it as grounds for denying the summary judgment motion – his co-counsel who briefly referred to it in the pleadings opposing summary judgment were found "not culpable"; (3) Mr. Duree had no knowledge of the alleged falsity of the amended return until after the charges were brought against him; (4) the amended return was not material to the summary judgment motion; (5) the amended return, which is alleged to be false because it lists fewer gross receipts than the weekly sales reports, could not have misled the court or DAI on any issue – the weekly

sales reports and the original tax return were before the court and DAI at all times.

The due process clause of the Fourteenth Amendment provides that Mr. Duree is entitled to have these defenses heard before a fair and impartial judge. Judge Russell was, admittedly, unable to be fair and impartial.

II. The Petition should be granted because the judgment of the Kansas Supreme Court conflicts with prior decisions of this Court holding that the due process right to a fair trial also requires the appearance of a fair trial and the prevention of even the probability of unfairness.

Although it is clear that the Kansas Supreme Court misapplied Kansas standards for recusal of trial judges under the Kansas "impartiality might be reasonably be questioned" standard, 95a, it is not the function of this court to review that ruling under Kansas law.

Although the Kansas standard appears to be the same as the federal standard under 28 U.S.C. §455, and it would appear clearly that the federal standard would require recusal and a new hearing, it is not the function of this court to review the Kansas ruling on those grounds. In terms of how the court would review this if the issue were raised under 28 U.S.C. §455, however, see Liljeberg v. Health Services Acquisition Corp., 486 U.S. 847 (1988), holding that 28 U.S.C. 455 requires a judge to

disqualify himself in any proceeding in which his impartiality might reasonably be questioned. See also, Liteky v. United States, 510 U.S. 540, 551-555 (1994). A favorable or unfavorable predisposition can be characterized as "biased" or "prejudiced" even if it springs from facts adduced or events occurring at trial (instead of an extrajudicial source) where it is so extreme as to display a clear inability to render a fair judgment, and even the court's judicial rulings may reveal bias and prejudice where they are derived from an extrajudicial source or where they reveal such a high degree of favoritism or antagonism as to make fair judgment impossible.

While this issue is not presented under 28 U.S.C. §455 or its Kansas equivalent, those standards may be of some help in determining whether Mr. Duree was afforded due process under the Fourteenth Amendment which requires a fair trial before a fair tribunal – including the prevention of even the probability of unfairness. In re Murchison, 349 U.S. 133, 136 (1955). Withrow v. Larkin, 421 U.S. 35, 46, 47 (1975) "Not only is a biased decisionmaker constitutionally unacceptable but 'our system of law has always endeavored to prevent even the probability of unfairness.'" 349 U.S. 133, 136 "Every procedure which offers a possible temptation to the average man as judge...not to hold the balance nice, clear and true between the state and the accused, denies the latter due process of law." Tumey v. Ohio, 273 U.S. 510, 532 (1927). See also Ward v. Village of Monroeville, 409 U.S. 57, 59 (1972). 349 U.S. 133, 136. "But to perform its highest function in the best way, 'justice must satisfy the appearance of justice.'" Offutt v. United States, 349 U.S. 11, 14, (1954). The

due process clause demarks only the outer boundaries of judicial qualifications. Aetna Life Ins. Co. v. Lavoire, 475 U.S. 813, 828 (1986). The Kansas courts clearly breached the due process boundaries in this case.

Constitutional due process requires prevention of the probability of unfairness and the appearance of justice, i.e., the appearance of a fair trial before a fair tribunal. Our system of justice requires a reasonable level of confidence, by the public at large, that every citizen will receive a fair trial before a fair tribunal. The Kansas courts clearly acknowledge that such public confidence is terribly eroded by the *ex parte* conversation, Judge Russell's erroneous conclusions drawn therefrom and the timing of her rulings. 78a, 105a, 106a.

The Kansas Supreme Court affirmed Judge Sheppard's finding that "the timing was absolutely terrible in terms of eroding confidence in the independent exercise of judgment on the part of Judge Russell." 105a, 106a. The Kansas Supreme Court also held that Judge Russell's conduct was "clearly inappropriate" under the Kansas canons of judicial conduct and that the conduct of John Gerstle was clearly inappropriate under the Kansas rules of conduct applicable to attorneys. 106a.

These findings by the Kansas Supreme Court cannot be squared with Mr. Duree's Fourteenth Amendment due process rights which require the prevention of even the probability of unfairness, and

the appearance of justice, i.e., the appearance of a fair trial before a fair tribunal.

CONCLUSION

For the foregoing reasons, petitioner, David M. Duree, respectfully submits that this Petition should be granted.

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APPENDIX

IN THE DISTRICT COURT OF
JOHNSON COUNTY, KANSAS
CIVIL COURT DEPARTMENT

SUBWAY RESTAURANTS, INC.,

Plaintiff,

v.

Case No. 91C2679
Court 7

NANCY KESSLER and
DANE BANKS,

Defendants.

June 9, 1995
MEMORANDUM OPINION

This matter came for argument on April 13, 1995, on the plaintiff's motion for summary judgment on the counterclaims filed by the defendants. Plaintiff appeared by Edward Dunham and Stanley Wilkins. The defendants appeared by David Duree, Don Webber and Su Linda Jamison.

The parties made their oral arguments, and the matter was taken under advisement in order that the Court could review in more detail the voluminous briefs and record excerpts submitted on the motion. After reviewing the parties' briefs and exhibits, as well as the supplemental briefs submitted by counsel after the oral arguments, the Court finds that summary judgment must be entered for the plaintiffs on defendants' counterclaims.

This case began its existence as an eviction action filed by Subway Restaurants, Inc., (hereinafter SRI)

against Nancy Kessler and Dane Banks, its tenants. Kessler and Banks were also franchisees of Doctor's Associates (hereinafter DAI), the franchisor for Subway Restaurants, and they leased the equipment for their Subway sandwich shop from Subway Equipment Leasing Corporation.

Kessler and Banks then filed a counterclaim against SRI and related entities. Repetition of the somewhat tortured history of the pleadings in this case is not necessary: suffice it to say that they have winnowed their claims down to a single cause of action for fraud, as set forth in their Fifth Amended Counterclaim. They request that punitive damages be awarded in addition to actual damages.

The plaintiffs' brief in support of its motion for summary judgment sets forth two hundred and sixty seven separately numbered facts, which plaintiff alleges are uncontroverted. Most of the statements of fact are either taken directly from the documents that were exchanged between the parties (such as The Subway Uniform Franchise Offering Circular, The Franchise Agreement, and various brochures and manuals given to the franchisees) or they are taken directly from the deposition testimony of Nancy Kessler.

The response filed by the defendants admits some of the facts, but attempts to deny most of the facts set forth in plaintiff's brief. A great many of the facts set forth by plaintiffs are not denied, but defendants state they object to the fact on the ground of relevancy and

move to have it stricken and have sanctions assessed against plaintiff. A great many more facts are denied by defendants without citation to the record.

S. Ct. Rule 141(b) requires a party opposing a motion for summary judgment to file:

> ... a memorandum or brief setting forth in separately numbered paragraphs (corresponding to the numbered paragraphs of movant's memorandum or brief) a statement whether each factual contention of movant is controverted, and if controverted, a concise summary of conflicting testimony or evidence, and any additional genuine issues of material fact which preclude summary judgment (with precise references as required in paragraph [a] supra).

Paragraph (a) of Rule 141 of course requires precise references to the record - depositions, documents, affidavits, etc. - where the factual contentions can be located.

Rule 141(c) provides that the effect of failure to comply with Rule 141(b) is to have the movant's uncontroverted contentions of fact deemed admitted. Baldly stating that a fact is contested, controverted or denied, without citing to the factual record where conflicting evidence is located, does not satisfy Rule 141(b). Danes v. St. David's

Episcopal Church, 242 Kan. 822, 830 (1988).

The Court has reviewed with care the defendants' responses to plaintiff's allegations of uncontroverted fact. Most of the denials contained in defendants' response do not include any citations to the record where conflicting evidence can be found. After sifting through defendants' response, the Court finds that the following numbered paragraphs in plaintiff's motion are genuinely in controversy, due to conflicting evidence in the record: 143, 150, 159 and 183. Further, there is a quasi-controversy over facts 202, 203, 207, 208, 209 and 210, all of which deal with the alleged assistance given to defendants by Mr. Grimes and Mr. Maass, the development agents who acted as Subway's representatives to provide field support and assistance to franchises. Kessler admits they did the acts set forth in these paragraphs, but denies it was of any assistance to her. She characterizes their acts as harassment and intimidation rather than help.

Further there is a quasi-controversy about paragraphs 138, 141, 142, 153, 154, 155, 156, 157 and 167, which are all factual contentions based upon the analysis of three accountants (Sieffert, Kaplan and Karn) of the books of the business. Kessler alleges that these analyses, including that of her own accountant, Robert Sieffert, are not reliable because their books and records are so incomplete as to afford no basis for anyone to draw conclusions from them.

The Court has concluded that there is only a good faith controversy concerning facts 143, 150, 159 and 183, and the Court does not deem these facts to be material.

All of the other factual contentions set forth in plaintiff's motion are found to be uncontroverted. Rather than setting the facts out again in this opinion, all facts except those numbered 143, 150, 159 and 183 are incorporated herein by reference, and will be referred to only as needed in discussion of the legal issues.

Before turning to a discussion of why defendants' claims are to be disposed of by summary judgment, it is helpful to review the basis for their fraud claim. The defendants set forth some thirty-seven factual allegations which they claim were fraudulent. These are found at paragraphs 16 and 21 of their counterpetition.

Defendants claim that many of the promises made to them by brochures, the Uniform Franchise Offering Circular, and Subway sales representatives did not comply with FTC regulations for franchising, and the offering brochures therefore were fraudulent when plaintiff stated that it was in compliance with all applicable laws and regulations. Defendants also claim that many of the promises they received both through statements of Subway agents and the written materials were fraudulent. In other words, defendants claim they were fraudulently induced to enter into the contract.

Defendants also claim that Subway's promises of assistance in selecting a site for their sandwich shop, obtaining financing and setting up their operation were not fulfilled, so they claim that Subway fraudulently promised to assist them in setting up their operation.

Another category of promises made by Subway which defendants claim were fraudulent concerned promises for assistance in day to day operations. Defendants claim that the assistance provided to them by Mr. Grimes and Mr. Maass (their local Development Agents) fell short of the level of assistance promised by Subway. They also contend that the Franchisee Advertising Fund was not operated in accordance with Subway's promises.

Defendants further allege that Subway fraudulently represented it would arbitrate disputes between it and its franchisees rather than litigate them in court.

The bases upon which summary judgment is entered on all of the above claims are set forth below.

Defendants Cannot Prove Causation.

Defendants lost their franchise and lost the money they invested in their franchise. The central and fundamental question that this case poses is this: Have the defendants brought forth any evidence that their losses were occasioned by fraudulent actions on the part of plaintiff?

After reviewing the evidence gathered by both parties during discovery, the Court is persuaded that the answer to the foregoing question is "no".

Fraud has been defined by the Kansas Supreme Court in Nordstrom v. Miller, 227 Kan. 59, 605 P.2d 545 (1980):

> Actionable fraud includes an untrue statement of fact, known to be untrue by the party making it, made with the intent to deceive or recklessly made with disregard for the truth, where another party justifiably relies on the statement and acts to his injury and damages. (Citations omitted.)
>
> We have held fraud is never presumed and must be proven by clear and convincing evidence. (Citations omitted.) 227 Kan. at 65.

Defendants' claims commingle claims of fraud by misrepresentation with claims of fraud by concealment. Fraud by concealment is also clearly defined under Kansas law:

> To establish fraud by concealment or silence, a plaintiff must demonstrate the following elements by clear and convincing evidence: (1) that defendant had knowledge of material facts which plaintiff did not have and which

> plaintiff could [not] have discovered by reasonable diligence; (2) that defendant was under an obligation to communicate the material facts to the plaintiff; (3) that defendant intentionally failed to communicate to plaintiff the material facts; (4) that plaintiff justifiably relied on defendant to communicate the material facts to plaintiff; and (5) that plaintiff sustained damages as a result of defendant's failure to communicate material facts to the plaintiff. Flight Concepts Ltd. Partnership v. Boeing Co., 819 F. Supp. 1535, 1545 (D. Kan. 1993).

It would appear that at least in part, defendants' counterpetition also alleges fraud based upon the promise of future events (i.e. the promise of assistance in site selection, getting financing, and operating the store). Kansas law recognizes a cause of action for fraud based upon the promise of future events. The difference between fraud relating to future events and ordinary fraud is cogently explained in Flight Concepts:

> Generally, fraudulent representations to constitute actionable fraud must relate to some material past or existing fact. (Citation omitted.) In order to prove a claim for fraud relating to future events, a plaintiff must show

> that the defendant had no intention of performing his promise at the time he made it. (Citation omitted.) The gravamen of such a claim is the existence of other circumstances of substantial character which support an inference of wrongful intent at the time of making the representations. (Citation omitted.) 819 F. Supp. at 1548-49.

The party claiming fraud must prove each of the five elements of fraud by clear and convincing evidence. "Clear and convincing evidence" has been defined thus:

> (T)he witnesses to a fact must be found to be credible; the facts to which the witnesses testify must be distinctly remembered; the details in connection with the transaction must be narrated exactly and in order; the testimony must be clear, direct and weighty; and the witnesses must be lacking in confusion as to the facts at issue. Modern Air Conditioning, Inc. v. Cinderella Homes, Inc., 226 Kan. 70, 78, 596 P.2d 816 (1979).

This Court is mindful that the defendants are not required to prove their case by clear and convincing evidence at the summary judgment stage of the proceedings.

In the context of fraud, the Kansas Supreme Court has stated that, although a party alleging fraud must prove it by clear and convincing evidence, 'a party resisting a motion for summary judgment need not present this quantum of evidence in order to succeed in opposing the motion.' Gorhan State Bank v. Sellens, 244 Kan. 688, 691, 772 P.2d 793 (1989). The Supreme Court has subsequently opined that clear and convincing evidence is a quality and not a quantum of proof. Barbara Oil Co. v. Kansas Gas Supply Corp., 250 Kan. 438, 448, 827 P.2d 24 (1992).

The general rule is that fraud is never presumed and must be proven by clear and convincing evidence. The trial court incorrectly applied the trial evidentiary standard to the motion for summary judgment. There are no special tests for a court to apply when a motion for summary judgment is considered. A party resisting a motion for summary judgment in an action based on fraud need not present 'clear and convincing' evidence of fraud in opposing the motion. The usual rules governing the ruling upon motions for summary judgment apply to actions based on fraud. Credit Union of

> America v. Myers, 234 Kan. 773, 780-81 (1984) (citations omitted).
>
> Summary judgment is proper only if there are no genuine issues as to any material fact. The trial court, in ruling upon the motions for summary judgment, may not determine factual issues; instead, the trial court should search the record to determine whether issues of material fact do exist. Pleadings and documentary evidence must be given a liberal construction in favor of the party against whom the motion is directed. If there is a reasonable doubt as to the existence of issues of fact, a motion for summary judgment should not be sustained. Dugan v. First Nat'l Bank in Wichita, 227 Kan. 201, 207, 606 P.2d 1009 (1980).

Even construing Kessler's deposition testimony in the light most favorable to the defendants and construing her experts' testimony in the light most favorable to the defendants, the Court must conclude there is no evidence that defendants' losses were caused by the fraud or misrepresentation of the plaintiff.

However, the evidence of defendants' mismanagement of their store is overwhelming. The only conclusion that a jury could rationally reach is that the

defendants failed in their business because of their mismanagement.

The history of the defendants' poor management decisions begins with building their store. They borrowed $48,000.00 to finance the construction and start up of their shop. They immediately took a portion of this sum out for living expenses and other unrelated expenses, leaving themselves $5,000.00 to $6,000.00 short of what they estimated to be their necessary start up costs of $44,900.00. Ms. Kessler explained that she felt justified in taking this money out because she and Mr. Banks had put the $7,500.00 franchise fee up out of their own pocket and she was simply reimbursing herself and Mr. Banks. She then hired a contractor to do the necessary improvements at a cost of $35,000.00, 75% more than the $20,000.00 cost estimate for leasehold improvements recommended by the General Information Brochure.

These facts meant that the defendants opened their store in April, 1988, with no operating funds.

This fact, combined with Ms. Kessler's apparent inability to keep books and records in her store, meant that the operation was conducted in financial chaos from the start. Ms. Kessler retained Gary Kaplan, an accountant, who came in and explained her tax obligations (payroll and sales) and general record keeping practices. He gave her a form to use in keeping a record of cash payouts and instructed her to record on all transactions on check stubs, including the amount, identity of

the recipient and purpose for which the check was written.

Ms. Kessler admits that she ignored this advice. She tore checks out of the checkbook and wrote them without recording the recipient, purpose or amount. She wrote checks out of the business account for personal expenses. She did not keep any consistent or clear record of cash payouts. In short, Mr. Kaplan characterized her books and records as "shoddy" and "a nightmare."

Mr. Karn, an accountant hired by plaintiff to examine defendants' books and records, testified that they demonstrated mismanagement and bad business practice. Examples of defendants' mismanagement and bad business practice pointed out by Mr. Karn included the store's use of seven different accounts at four different banks in its 19 months of operation, and 224 bounced checks during that period of time, resulting in more than $3,000.00 in bad check charges. He testified that this level of bounced checks (the first of which happened within three weeks of the store's opening) was as high as he had ever seen in his thirty years as an auditor/accountant.

Mr. Karn also compared the store's bank records and the Weekly Inventory and Sales Reports which the defendants were required to prepare weekly and submit to DAI. Mr. Karn concluded that during the first thirteen months of the store's operation, the defendants failed to deposit at least $112,219.38 in cash receipts into their bank accounts.

Kessler admits that they failed to deposit about half of the store's cash receipts, but explains that they did this because food vendors required them to pay in cash rather than by check because of their problems with bounced checks. She is unable to say exactly how much money they failed to deposit as she kept no records.

What portions of the undeposited sums were used to pay food vendors is impossible to determine, because the defendants, according to Kessler's own testimony, did not keep any records of what they paid out in cash. Mr. Kaplan, the accountant they hired to help them set up their bookkeeping, records and tax records, testified that he carefully explained to Kessler the necessity of keeping cash paid-out records as well as other kinds of records when he met with her on May 2, 1989, and gave her suggested forms to fill out to do so. He made a follow-up visit to the store on August 10, 1989, and found that none of his suggestions had been followed, so he went through a review with Kessler of everything he had covered in their first meeting. Mr. Karn's testimony establishes that these procedures, twice explained by Mr. Kaplan, were never followed, as the problems continued throughout the life of defendants' franchise operation.

The defendants hired an expert, Mr. Sieffert, to analyze their operations, and attempt to refute the conclusions drawn by Mr. Kaplan and Mr. Karn through Mr. Sieffert's testimony. Mr. Sieffert's testimony in this regard is rather

surprising. He testified that the books and records kept by the defendants are so bad that "you cannot make any business decisions from (them)."

This fact alone merits the granting of summary judgment in this case. At trial, the defendants would be required to establish a causal connection between the alleged fraud and the business failure by clear and convincing evidence. If defendants were keeping such poor records that no business decisions can be made from them, they will never be able to establish that they would have succeeded but for the alleged fraud of the plaintiff.

Defendants attempt to argue in their brief that traditional notions of causal connection do not apply. What standard they believe should be applied to measure the connection between the alleged fraud and the damages is not terribly clear, but case law makes it plain that they are wrong.

A case cited by plaintiff, Criqui v. Pearl Music Co., Inc., 41 Or. App. 511, 599 P.2d 1177 (1979) explains in clear, easily comprehensible terms, the connection that must be proved between the alleged fraud and damages. Criqui also involved the purchase of a business opportunity, and the evidence in that case was quite clear: the seller made outright lies to the buyer in marketing the business opportunity. The buyer's business subsequently failed, and he sued alleging fraud. The Oregon Court of Appeals reversed the judgment on the issue of damages, based upon the fact

that plaintiff had not proved a causal connection between all of his damages and the alleged fraud. In reaching this decision, the court held:

> There was no evidence that the misrepresented matters on which plaintiff relied in any way caused the income of the business to be less or expenses to be greater during the period plaintiff operated it. There may have been evidence from which the jury could have inferred that plaintiff would not have purchased the business had it not been for the misrepresentations, and he testified that he did rely on the representations. Such 'but for' causation, however, is not sufficient by itself to establish the link between the wrong and the damage claimed. (Citation omitted.) If it were, a person who had been induced to enter into any business by a fraudulent misrepresentation could recover for any loss he might thereafter suffer in the business, regardless of whether there was any relationship between the loss and the misrepresentation. For example, a person who bought a restaurant (real property, equipment and good will) which was falsely represented to be free from termites could experience a net operating loss because he served bad food and

> still recover that loss in a fraud action based on misrepresentation. While there is no sympathy for one who commits fraud, such attenuated causation is not a sufficient basis for holding one responsible to make up every loss that would not have occurred had there been no fraud. 559 P.2d 1180-1181.

The same principle was followed in Canterbury Court, Inc. v. Rosenberg, 224 Kan. 493, 582 P.2d 261 (1978). Canterbury Court involved fraud in the sale of a business. The seller had represented to the buyer that the business had grossed $140,000.00 in the year prior to the sale, when in fact it had grossed substantially less ($117,742). The Supreme Court rejected plaintiffs' claims for damages, however, because in the year plaintiff purchased the business it grossed $149,572.00, and in the following year it grossed $164,889.00. Plaintiff's claim was denied by the Court because, although they were fraudulently led to believe they were purchasing a business that had grossed $140,000.00, in the two following years it grossed substantially more. The Court reasoned:

> (T)he mere proof of the making of a false statement does not prove actionable fraud; it is incumbent upon one who bases a claim upon fraud to prove that fraud caused the injury or loss. (Emphasis added.)

. . .

> Though the giving of false information is or may be morally wrong, the false information relied upon must be the cause of injury before a claim for actionable fraud arises. . . (Emphasis added.) 224 Kan. at 502.

Both Crigui and Canterbury Court cited and relied on Prosser, Torts, 732 Sec. 110, (4th Ed. 1971).

> So far as the fact of causation is concerned, any loss which follows upon a transaction into which the misstatement induces the plaintiff to enter may be said to be caused by it; but the same considerations which limit liability in cases of tangible harm have operated here. In general, with only a few exceptions, the courts have restricted recovery to those damages which might foreseeably be expected to follow from the character of the misrepresentation itself. Thus if the plaintiff stores his goods in a warehouse represented to him to be fireproof, and they are destroyed when it burns down, he can recover; and likewise where he invests in an automobile agency after false assurances of profit made by similar agencies, and goes bankrupt. But if false

> statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery. It is only where the fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered. Sometimes this has been expressed by saying that the representation in such a case is immaterial to the result; but the conclusion is reached even though the plaintiff has in fact relied, and justifiably so, upon what he has been told. Prosser, Law of Torts, 732 Sec. 110 (4th Ed. 1971). (Footnotes omitted.)

The law is clear. Defendants must prove by clear and convincing evidence that plaintiff made false statements regarding material facts, and that their reliance on the false statements caused their damages. Given the overwhelming evidence of defendants' own mismanagement and refusal to follow business procedures set out by Mr. Kaplan and the various Subway manuals, there is no way that they could sustain their burden of proving by clear and convincing evidence that their business losses were caused by any of plaintiff's alleged misrepresentations. Defendants have brought forward no evidence to controvert the facts alleged

by the plaintiff in this regard. The impossibility of their proving that their losses are due to anything but their own mismanagement is borne out by defendants' own expert's testimony that the books and records they maintained are so chaotic that no business decisions can be made from them.

The Court finds that defendants' claim must fail overall because they will not be able to prove that their damages are due to anything but their own mismanagement. However, the Court also finds specifically that the alleged fraudulent representations set forth in the following paragraphs of defendants' counterpetition fail, because they do not meet the fundamental test of causation established by Canterbury Court, Crigui, and Sec. 110 of Prosser: paragraphs 16(a)(1), (6), (7), (8), (9), (12), (13), (14); 16(b)(5), (6), (7); 16(c)(1), (2), (3); 16(d)(1); 16(e)(3), (4); 16(f); 16(g); and the entirety of paragraph 21. These alleged misrepresentations are immaterial to their losses.

Claims for Which Defendants Admit They Have No Proof Of Falsity.

Kessler admitted in her deposition that she has no proof of the falsity of some of the defendants' alleged fraudulent statements. These include paragraphs 16(a)(1), 16(a)(4), 16(a)(6), 16(a)(7), 16(a)(10), 16(a)(12), 16(a)(13), 16(b)(7) and 16(c)(2).

Although she claims that Subway's representation that the only cooking required is bread-baking is in fact

false, as franchisees also have to bake cookies, she admitted in her deposition that this representation was not material.

The hallmark of a fraud claim is that a party claiming fraud must prove that the alleged fraudulent statements are false. Further, "fraud is never presumed and must be proved by clear and convincing evidence." Nordstrom v. Miller, 227 Kan. 59, 65,605, P.2d 545 (1980). After five years of exhaustive discovery defendants still have no proof of the falsity of these statements. It is not just that they cannot sustain their burden of proving the falsity of these statements; they have no proof whatsoever. Therefore plaintiff is entitled to summary judgment on defendants' fraud claim as it pertains to these allegations.

There Is No Private Cause of Action for Violation of the FTCA.

Much of defendants' responsive brief is devoted to arguing that many of the claims and promises made in Subway's brochures and the Uniform Franchise Offering Circular and by Subway representatives concerned the probability of future financial success by Subway franchisees, and that these predictions of future financial success are prohibited by The Federal Trade Commission.

The law is perfectly clear that the FTCA confers no private right of action. The exclusive remedial power under the FTCA lies with the Federal Trade

Commission. American Airlines v. Christensen, 967 F.2d 410, 414 (10th Cir. 1992); Baum v. Great Western Cities, Inc., 703 F.2d 1197 (10th Cir. 1983); Fulton v. Hecht, 580 F.2d 1243 (5th Cir. 1978).

Defendants' argument appears to be this: although there is no private cause of action for violations of the Federal Trade Commission Act, there is a private cause of action for fraud for Subway's statement that its offering circulars and brochures complied with the FTCA, when in fact they do not.

This Court makes no determination of whether Subway's offering circulars and brochures or any other of its methods of recruiting franchisees complied with the FTCA regulations. That matter is strictly within the purview and expertise of FTC regulators. This Court's holding is that defendants' allegations of fraud centering around FTC violations are a thinly-veiled step transaction. What one cannot do directly, one cannot do indirectly.

Therefore, plaintiff is entitled to summary judgment on this portion of defendants' counterclaim.

Defendants' Claim Based Upon Subway's Failure to Arbitrate.

The franchise agreement entered into between the parties provides that they will arbitrate any disputes between the franchisor and the franchisee. In order to understand this claim, one must

understand the relationship between all parties to this lawsuit.

Doctor's Associates, Inc. is the franchisor. The Franchise Agreement was entered into by DAI and the defendants. The Franchise Agreement provided that defendants were to select the site where they wished to locate their store, which would then be leased from the landowner by Subway Restaurants, Inc., a separate (but obviously closely related) entity. SRI would then sublease the premises to the franchisee.

The defendants' complaint on this point is that DAI's promise to arbitrate disputes between itself and the franchisee is fraudulently illusory, because what DAI failed to tell the defendants was that SRI was not similarly bound to arbitrate disputes with its sublessees, who are, of course, DAI's franchisees.

What actually happened in this case was that SRI commenced an eviction action against the defendants in district court when difficulty arose with the defendants. Defendants' claims of fraud based upon these facts are found at paragraph 16(b)(5), (6) and (7) of their Fifth Amended Counterpetition.

This might serve as grounds for trying a fraud by concealment case, but for one important fact: defendants have clearly stated they do not wish to arbitrate. Kessler testified in her deposition that she was cognizant of the arbitration clause in the Franchise Agreement, but they had never made a

request to the American Arbitration Association. When offered the option of arbitration during her deposition, she plainly stated that she did not wish to arbitrate.

Since defendants have knowingly waived their right to arbitrate, plaintiffs' alleged duplicity on this point cannot be found to be material.

In order for a misrepresentation to be actionable, it must be as to a material fact. Since this fact is clearly not material to the defendants, plaintiffs are entitled to summary judgment on defendants' fraud claims based upon plaintiff's promise to arbitrate.

Parol Evidence Rule

Plaintiffs also advance a meritorious argument that many of defendants' claims of fraud as set forth in their Fifth Amended Counterpetition are barred by the parol evidence rule, as they related to alleged misrepresentations made prior to the execution of the contract. Defendants rather colorfully characterize plaintiff's reliance on the parol evidence rule as "the last refuge of the scoundrel" and point to the well recognized exception to the parol evidence rule for fraud in an attempt to save their claims.

The interplay between fraud and the parol evidence rule is a difficult concept, but after considering the case law in light of the facts of this case,

the Court is persuaded that plaintiff is correct in asserting that the parol evidence rule precludes many of defendants' allegations of fraud.

The parol evidence rule precludes the admission of evidence of prior or contemporaneous oral agreements to vary the written contract. The effect of the rule is succinctly stated in Albers v. Nelson, 248 Kan. 575, 809 P.2d 1194 (1991):

> Where contracting parties have carried out negotiations and have subsequently entered into an agreement in writing with respect to the subject matter covered by such negotiations, the written agreement constitutes the contract between them and determines their rights. 248 Kan. at 578.

The Albers court goes on to recognize the well known exception to the parol evidence rule upon which defendants rely:

> Thus, the contract here is binding as written unless the Nelsons plead and offer evidence of fraud in its inception under which circumstances parol evidence may be admitted to vary the terms of the written agreement. 248 Kan. at 579.

An even stronger statement of the principle was set forth in Hawthorn-

Mellody, Inc. v. Driessen, 213 Kan. 791, 518 P.2d 446 (1974):

> A well recognized exception to the parol evidence rule permits the use of evidence of fraudulent representations made during the course of negotiations where a contract is procured or induced by the fraudulent representations of one of the parties which were relied upon by the other. (Citations omitted.) The parol evidence rule simply has no application where the issue is fraud in the inducement to contract as is raised in this case. 213 Kan. at 795.

Defendants argue vigorously that this long recognized exception to the parol evidence rule provides them with a way over the bar generally posed by the rule, and permits them to introduce all prior statements, which they allege are fraudulent.

Responding to this argument, plaintiffs point out that the law also recognizes an "exception to the exception", and the evidence sought to be used by defendants falls within the exception to the exception. The Court must agree with the plaintiff, based upon an examination of the contract as it compares to the prior, allegedly false, statements. In Edwards v. Phillips Petroleum Co., 187 Kan. 656, 360 P.2d 23 (1961), the Court stated:

> . . .where, however, the written contract, to the promisee's knowledge, reveals that falsity of the oral promise, the promisee cannot invoke the rule that fraud may be predicated on a promise made without the intention of performance. 187 Kan. at 660.

The Court went on to quote from 32 C.J.S., Evidence, Sec. 979d, p. 952:

> . . .thus the evidence must tend to establish some independent fact or representation, some fraud in the procurement of the instrument, or some breach of confidence concerning its use, and not a promise directly at variance with the promise of the writing. (Emphasis added.) 187 Kan. at 661.

The exception to the exception was applied in Edwards to preclude plaintiff's attempt to introduce evidence that they had been promised that no additional wells would be drilled on their land when they entered into a unitization agreement. The Supreme Court held that they could not introduce such evidence, as:

> (t)here was nothing in the unitization agreement to indicate there was to be no development of the plaintiffs' tract. By the unitization agreement the plaintiffs expressly acknowledge to each

> of the other 'Royalty Owners' executing the agreement that 'no representations not incorporated in the agreement have been made to them and that the instrument has been executed and delivered unconditionally.' 187 Kan. at 661.

The exception to the exception was again invoked in Flight Concepts Ltd. Partnership v. Boeing Co., 819 F. Supp. 1535 (D. Kan. 1993) to bar plaintiff's attempt to introduce alleged misrepresentations directly at variance with the written contract. The Court in Flight Concepts quoted the following comments from Turner v. Johnson & Johnson, 809 F.d 90, 95-96 (1st Car. 1986):

> (A) contractual provision flatly contrary to prior oral assurances should cause most people - and particularly experienced, knowledgeable business people - to pause. Moreover, if a jury is allowed to ignore contract provisions directly at odds with oral representations allegedly made during negotiations, the language of a contract simply would not matter anymore. Even if a sales contract provided that the product for sale is old, the buyer could claim that she purchased it only because the seller said it was new. Contracts would become no more than presumptive statements of

> the parties intentions, instead of legally enforceable agreements.

The Court has examined the defendants' Fifth Amended Counterclaim. At a minimum, the following alleged misrepresentations pre-date and are directly contradicted by the clear provisions of the Franchise Agreement: 16(c)(1), (c)(2), (c)(3); 16(d)(1); 16(e)(1), (e)(2), (e)(3), (e)(4), (e)(5); 16(f); 16(g).

The Franchise Agreement (which Kessler testified she read and understood prior to signing) provided in pertinent part:

> J. The Franchisee acknowledges that he understands the success of the business to be operated by him under this Agreement depends primarily upon his efforts and that neither the Company or any of its agents or representatives have made any oral, written or visual representations or projections of actual or potential sales, earnings, net or gross profits.
> . . .
>
> 12. . . . other than the representations contained in the Agreement, the Offering Circular and advertising materials of the Franchisor, no other representations have been made to or relied on by the Franchise except as set forth below:

(Note: four blank lines follow paragraph 12, which are provided for the Franchisee to fill in. On the copy of the Franchise Agreement signed by the defendants, the blanks are left blank.)

The Franchise Agreement, which is the contract between the parties, in the plainest possible terms states that the Franchisee is responsible for the profitability of the store and disavows any projections by anyone associated with Subway as to future profits. The contract further states that it is the Franchisee's responsibility to find an appropriate store site. In the "zipper clause" of paragraph 12, defendants had the opportunity to note any additional representations outside of the contract, but noted nothing.

Under these circumstances, to allow the defendants to argue at trial that contrary to the clear, direct provisions of the contract, they were given promises about the future profitability of the store, the low failure rates of Subway stores, the future value of their store, and that Subway would be responsible for choosing the best possible site for them simply flies in the face of contract law. They cannot negate the clear terms of the contract by parol evidence of promises that are directly contrary to those written terms.

The Remaining Claims

The Court has ruled that all of defendants' claims must be disposed of by summary judgment because they cannot prove that their losses flowed from anything but their own mismanagement and failure to follow the company's directions and procedures.

In addition, the Court has ruled that all but a few of defendants' claims of fraud must be disposed of either because they have no proof the statements were false; then claimed false statements are immaterial as defined by Sec. 110 of Presser; and there is no cause of action due to the parol evidence rule.

There remain a few claims that have not been addressed except under the general ruling that defendants cannot prove causation. These include allegations that Subway fraudulently promised to provide guidance and assistance by a Subway representative in setting up their operations, selecting a site, in obtaining financing, and in running the franchise operation after they had opened it.

These allegedly false promises appear at paragraphs 16(a)(2), (a)(3), (a)(5), (a)(11); 16(b)(1), (b)(2), (b)(3), and (b)(4). The Court is persuaded that these claims, too, must fail.

The allegedly false promises set forth above all concern promises of future performances and events. Kansas law recognizes a cause of action for

fraud relating to future events, although in general fraudulent representations, to constitute actionable fraud, must relate to a material past or existing fact. Tim v. Prescott State Bank, 220 Kan. 377, 553 P.d 315 (1976).

Discussing the viability of a fraud claim based upon future events, the court in Flight Concepts states:

> In order to prove a claim for fraud relating to future events, a plaintiff must show that the defendant had no intention of performing his promise at the time he made it . . . There must be more than mere non-performance to show fraudulent intent. . . . The gravamen of such a claim is the existence of other circumstances of substantial character which support an inference of wrongful intent at the time of making the representation. . . . (Citations omitted; emphasis added.) Flight Concepts Ltd. Partnership v. Boeing Co., 819 F. Supp. 1535, 1548-1549 (D. Kan. 1993).

The evidence in this case, as set forth in paragraphs 197-232 of plaintiffs' statement of uncontroverted facts, clearly show that defendants were dissatisfied with the assistance provided to them in selecting their store site, in obtaining financing, and in setting up and running their operation. But Kessler admitted that she had no evidence to

support her claim that DAI had no intention of providing her with this assistance at the time the contract was signed. Lacking such proof, their claim of fraud based upon future events fails.

The defendants may have a breach of contract claim for these alleged failures on the part of DAI and its agents. It may very well be that they did not receive adequate assistance from DAI in selecting a site for their shop, in getting financing for the venture, or in setting up and operating their store. The Court makes no finding regarding the viability of possible breach of contract claims, as their Fifth Amended Counterclaim contains no claim for breach of contract. In defendants' initial answer and counterclaim, they did assert a breach of contract claim but at some point in the evolution of their pleadings they dropped their breach of contract claim.

> An amendment which is complete in itself and does not refer to or adopt the prior pleading supersedes it and the original pleading ceases to be part of the record, being in effect abandoned or withdrawn. Shaeffer v. Schaeffer, 175 Kan. 629, 634, 266 P.2d 282 (1994).

Defendants' breach of contract claim has been abandoned and cannot be considered by this Court.

Throughout Kessler's deposition testimony on this issue there runs a common thread: she believes that the DAs

("development agents") assigned to assist her did not adequately perform their jobs because they were other franchisees who were in competition with her. She feels that they kept the best sites for themselves and that they engineered her failure in order to improve their businesses. She has no proof that either of these beliefs on her part are true. Her complaint may be that DAI should have revealed to her in advance of her signing of the contract that her DAs would be other local franchisees, but to the extent that is her claim, the evidence is quite clear that the Uniform Franchise Offering Circular, the Franchise Agreement, and the Operations Manual do reveal that the DAs will generally be other local franchisees.

Defendants' evidence fails to establish a necessary element of proof for a claim of fraud relating to future events, and plaintiffs are entitled to summary judgment on these portions of defendants' claims.

CONCLUSION

Plaintiffs are entitled to summary judgment on defendants' counterclaim in its entirety. Defendants have had ample time to conduct discovery and come forward with proof of plaintiffs' fraud and duplicity, but have not been able to do so.

In fact, the very basis of the contract would seem, as a matter of common sense, to negate Kessler's underlying notion that plaintiffs duped her into signing a franchise contract

which was designed to set her up to fail. The initial franchise fee for a Subway shop is low - only $7,500. Common sense would indicate that the franchisor's principal hope for making money from the franchise agreement lies in the 8% royalty payments it is to receive from the gross weekly sales. That being the case, it is obvious that the franchisor has a self interest in seeing that the franchisee succeeds.

Mr. Wilkins is requested to draw a journal entry of this judgment for the court's signature and for filing with the Office of the Clerk of the District Court.

IT IS SO ORDERED.

Dated: June 9, 1995

/ss/ Janice D. Russell
Janice D. Russell
Judge of the District
Court

IN THE DISTRICT COURT OF
JOHNSON COUNTY, KANSAS

SUBWAY RESTAURANTS, INC.,

Plaintiff,

v.

Case No. 90C12370
Court 7

KESSLER AND BANKS,

Defendant.

May 31, 1996
MEMORANDUM OPINION

This matter came on before the court on March 8, 1996, on plaintiffs' motions to revoke the *pro hac vice* admission of David Duree and for sanctions pursuant to K.S.A. 60-2007. The plaintiffs appeared by Edward Dunham and the defendants appeared by David Duree. The matter was continued to April 16, 1996 for further presentation of evidence, and the matter was taken under advisement.

This pending motion has arisen out of bitterly fought litigation between the parties. Originally the plaintiffs filed suit in 1990 against the defendants under lease contracts that they had entered into as part of a franchise arrangement. The defendants retained the services of David Duree in the spring of 1991, and he filed a counterclaim against the plaintiffs. The first counterclaim alleged a series of claims related to breach of contract. Thereafter, a series of amended counterclaims were filed.

Since the evolution of the defendants' counterclaims is relevant to these motions, a summary of the claims asserted is set out here:

July 19, 1991: Amended counterclaim filed alleging 1) breach of contract; 2) willful and wanton breach of contract; 3) fraud; and 4) tortious interference with contract.

September 19, 1991: Second amended counterclaim filed.

September 8, 1992: Third amended counterclaim filed alleging 1) fraud; 2) punitive damages based on fraud.

February 22, 1993: Fourth amended counterclaim filed alleging 1) fraud; 2) punitive damages based on fraud; 3) abuse of process; 4) punitive damages based on abuse of process.

May 12, 1993: Fifth amended counterclaim filed alleging 1) fraud; and 2) punitive damages based on fraud.

Discovery was lengthy and hard-fought, eventually necessitating the appointment of a special master to handle discovery disputes. Eventually, however, the discovery process was completed, and plaintiffs filed a motion for summary judgment on the defendants' counterclaims.

The pleadings relating to the motion for summary judgment eventually focused attention on the factual issue before the court in these motions. In plaintiffs' motion for summary judgment, plaintiffs relied upon the fact that the 1989 tax

return filed by Kessler and Banks actually showed a profit for the months that they had conducted business under the franchise agreement. In part, plaintiffs' argument for summary judgment was based upon the fact that defendants could not show any actual loss in their business, and therefore a fraud action could not lie.

Defendants, through Mr. Duree, vehemently argued that plaintiffs' argument was frivolous, as an amended 1989 tax return had been filed, showing a loss. On this basis, Mr. Duree demanded that sanctions be assessed against Mr. Dunham for frivolous pleadings. At the oral argument on the motion, there was a good deal of confusion on the part of attorneys for the defendants over whether the amended 1989 tax returns had actually been filed with the IRS, but it eventually was established to this court's satisfaction that the amended 1989 tax returns were indeed filed.

It is the amended 1989 tax return that is at the heart of the motions at hand. Mr. Dunham charges that Mr. Duree manufactured the amended 1989 tax returns to serve as a basis for the defendants' fraud claim. After carefully considering the evidence, the court has reluctantly concluded that Mr. Dunham is correct.

The original 1989 partnership tax return for the Kessler/Banks Subway Shop was filed on September 6, 1990. It was prepared by H&R Block. That return showed a modest profit for the months that the defendants operated their shop. The gross receipts for the shop on that return were taken from the WISRs which Nancy Kessler

filled out each week their shop was in operation.

The WISRs are documents utilized in shops operated under the Subway franchises. WISR is an acronym for Weekly Inventory and Sales Report. Nancy Kessler has testified in her deposition that the WISRs were relatively simple forms; that she understood how to fill them out; and that she did fill them out accurately each week that their shop was in operation.

Mr. Duree first entered his appearance in this case in 1991, several months after the original return was filed on September 6, 1990. In this case, as in the many other cases that Mr. Duree has brought against the Subway companies, he retained Mr. Seiffert, a CPA, to serve as his expert on financial matters relating to the litigation. In this case, he requested that Mr. Seiffert calculate the damages sustained by Kessler and Banks.

Mr. Seiffert conferred with him concerning the 1989 return. Mr. Duree testified that he learned that Seiffert, Kessler and Banks believed that the 1989 tax return was inaccurate because, despite what the 1989 tax return and the WISRs showed, Kessler and Banks *felt* like they had lost money in the operation.

At that point, according to Mr. Duree's testimony, he made the executive decision to have an amended 1989 tax return prepared, as a matter of trial strategy, because he knew that the original tax return would be a problem at trial because it showed a profit. He denies, however, that he decided to have a

false return prepared: his position is that he wanted a return that reflected Kessler's and Banks' feeling that they had lost money.

The amended 1989 return was prepared by Mr. Seiffert in January, 1993. It showed gross receipts based upon the total of bank deposit slips for the Kessler/Banks shop. The problem with calculating gross receipts from bank deposit slips is that Nancy Kessler testified that only 50% to 60% of the cash that came into their store was deposited into the bank. The rest was taken out of the till to pay food vendors, or for whatever else Kessler and Banks were using it for.

Seiffert testified in his deposition that he calculated the gross receipts from the bank deposit slips, because he did not believe that all of the WISRs were all available. However, the deposition record reflects that Mr. Dunham was able to locate in Mr. Seiffert's files every WISR for the weeks that Kessler and Banks operated their shop, and that he was able to pull them out in less than five minutes.

It is significant that Mr. Seiffert appended to the amended 1989 return a disclaimer to the IRS. In it he basically stated that he was not warranting the accuracy of any of the figures that appeared in the return. He testified that this is not his usual practice. In fact, he stated that he could not recall ever having done this before.

The inescapable conclusion from these facts is that Mr. Duree deliberately caused to be prepared a false tax return for use in this litigation.

The Model Rules of Professional Conduct plainly prohibit the manufacturing of false evidence for use in litigation. Several provisions of the code are applicable.

MRPC 3.3 provides:

A lawyer shall not knowingly:

(1) make a false statement of material fact or law to a tribunal; . . .

(4) offer evidence that a lawyer knows to be false.

MRCP 3.4 provides:

A lawyer shall not:

(a) unlawfully obstruct another party's access to evidence or unlawfully alter, destroy or conceal a document. . .

(b) falsify evidence, counsel or assist a witness to testify falsely, or offer an inducement to a witness that is prohibited by law; . . .

MRPC 8.4 provides:

It is professional misconduct for a lawyer to:

> (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation;
>
> (d) engage in conduct that is prejudicial to the administration of justice. . .

"The power to regulate the bar, including the power to discipline its members, rests inherently and exclusively with [the Supreme Court]." *State ex rel. Stephan v. Smith*, 242 Kan. 336, Syl. 12, 747 P.2d 816. This court recognizes and defers to the Supreme Court's power and authority to discipline attorneys licensed to practice law in this state. Were Mr. Duree licensed to practice law in Kansas, the court would certainly defer to the Supreme Court on questions relating to his suitability to practice. However, he is not a Kansas attorney. He has appeared in this litigation *pro hac vice*. Therefore, questions relating to his suitability to practice in Kansas courts in this litigation remain inherently within the power of this court.

Mr. Duree's authority to practice *pro hac vice* is hereby revoked. This revocation extends only to his authority, and does not affect the authority of Mr. Carter or Ms. Jamison, to whom no culpability in the matter is assigned.

Subway has also requested the award of $408,445.25 as sanctions under K.S.A. 60-2007. The statute provides, "[I]f the court finds that a party, in a pleading, motion, or response thereto, has asserted a claim or defense, including set offs and counterclaims, or has denied the truth of

a factual statement in a pleading or during discovery, without a reasonable basis in fact and not in good faith, the court shall assess against the party as additional costs of the action and allow to the other parties, reasonable attorney fees and expenses incurred by the other parties as a result of such claim, defense or denial. An attorney may be held individually or jointly and severally liable with a party for such additional costs. . ."

Mr. Dunham has submitted an affidavit showing that Subway has incurred $408,445.25 in attorney fees since the filing of the Fifth Amended Counterclaim on May 12, 1993. He argues that this amended counterclaim, which is the final pleading upon which plaintiffs rested their claims of fraud, was based upon the loss purportedly shown by the amended 1989 return. Therefore, plaintiffs are entitled to all of the attorney fees they paid after that date, because, but for the false return, their fraud claim could not have been filed.

Based upon the findings in this memorandum opinion and the affidavit of Mr. Dunham establishing plaintiffs' attorney fees, the court assesses sanctions against Mr. Duree in the sum of $408,445.25.

Mr. Dunham is requested to draw a journal entry setting forth the findings and conclusions contained in this memorandum opinion.

IT IS SO ORDERED.

Dated: May 31, 1998

/ss/ Janice D. Russell

IN THE DISTRICT COURT
OF JOHNSON COUNTY, KANSAS

DOCTOR'S ASSOCIATES,

Plaintiff,

v. Case No. 90C12370

DANE BANKS AND NANCY KESSLER,

Defendants.

July 19, 1996
TRANSCRIPT OF PROCEEDINGS

* * *

MR. DUNHAM: As I was saying, what I'd like to do, with the Court's permission, is briefly explain why we have approached the journal entry as we have and made the proposal that we did, and then talk about the governing case law, which I think illustrates why the objection from Mr. Duree is not well-founded.

To state the obvious, this is not a typical ruling on a typical issue with typical opposing counsel. It was an extraordinary ruling on extraordinary facts.

As a consequence of that ruling, Mr. Duree is now, I think, in real peril of losing his license to practice law. Your Honor advised the lawyer disciplinary authorities in both Illinois and Missouri of the opinion because you sent them a copy of the opinion. And although I have no inside information or outside

information, it is difficult for me to believe that those disciplinary authorities are not going to regard this misconduct with the utmost seriousness.

I think as a consequence of that, it is - we know from Mr. Duree's behavior before you that he is going to do everything he can - everything he can - to distort the record and confuse the Court of Appeals to get your decision overturned.

* * *

As I said, all we're trying to do under these highly unusual circumstances is to make sure that this record is buttoned up as tightly as possible to give Mr. Duree as little room as possible to go through the machinations we can all predict he will go through before the Court of Appeals.

* * *

THE COURT: Well, I've reviewed this morning, while I've been listening to your arguments, the journal entries that both sides have prepared, and I don't see anything in the journal entry prepared by Mr. Dunham that is not included in the decision that I issued. I think that the Court of Appeals will look at both the memorandum decision and the journal entry in assessing the correctness or wrongness of my decision.

The fact that a journal entry is filed will not keep them from taking a look at the memorandum opinion. In fact, I think that is mainly what they look at

when they determine the correctness of the Court's decision. So I'm going to sign the journal entry prepared by Mr. Dunham.

IN THE DISTRICT COURT OF
JOHNSON COUNTY, KANSAS
CIVIL COURT DEPARTMENT

SUBWAY RESTAURANTS, INC., SUBWAY EQUIPMENT LEASING CORP. and DOCTOR'S ASSOCIATES, INC.,	) No. 91-C-2679) Court No. 7;) Chapter 60
Plaintiffs,	) Formerly) No. 90-C2344) Court No. 1;) Chapter 61
vs.	)
NANCY KESSLER and DANE BANKS,	) (Consolidates w/) No. 90-C-12370) Court No. 7;) Chapter 60)
Defendants.	)

July 19, 1996
JOURNAL ENTRY

On March 8, 1996 and April 16, 1996, the above matter came on for hearing on the October 5, 1995 Motion of plaintiff Doctor's Associates, Inc. ("DAI") for Attorneys Fees and Costs against defendants' lead counsel, David M. Duree, Robert C. Carter, and the law firm of Reinert & Duree of St. Louis, Missouri ("Motion for Fees and Costs"), and DAI's November 10, 1995 Motion for an Order Revoking Mr. Duree's *Pro Hac Vice* Admission in this Case ("Motion To Revoke"). DAI was represented at both hearings by Stanley N. Wilkins from the law firm of Turner & Boisseau, Chartered, of Overland Park, Kansas, and Edward Wood Dunham from the law firm of Wiggin & Dana, of New Haven, Connecticut. Messrs. Duree and Carter, and Reinert & Duree were represented by Mr. Duree at both hearings,

by Su Linda Jamison of the Barnett Law Firm of Overland Park at the March 8, 1996 hearing, and by Kathryn P. Barnett, also of the Barnett Law Firm, at the April 16, 1996 hearing.

In support of its Motions, DAI submitted memoranda of fact and law and supporting evidence, and additionally called as a witness at the March hearing Professor Geoffrey C. Hazard, Jr. In opposing the motions, Messrs. Duree and Carter and Reinert & Duree submitted affidavits by Mr. Duree, Robert Seiffert, and Jerome Marchbein, all dated December 18, 1995, as well as additional evidence, and called as witnesses at the April hearing John Nicholas Badgerow and Mr. Duree. Following the hearings, Messrs. Duree and Carter submitted a supplemental brief on April 17, 1996, to which DAI responded on April 25, 1996.

The Court, after having carefully considered all oral arguments, written submissions and evidence presented by DAI and Messrs. Duree and Carter and Reinert & Duree, finds that:

1. Following his appearance in this case in the spring of 1991, Mr. Duree directed that five different versions of defendants' counterclaim against DAI be filed alleging various claims, culminating in the Fifth Amended Counterclaim ("Counterclaim") of May, 1993. Although defendants' earlier pleadings charged DAI with a variety of tortious conduct, the Counterclaim reduced defendants' claims to a single count of fraud and sought punitive damages.

2. Mr. Duree retained as defendants' financial expert Robert Seiffert, who has served as Mr. Duree's expert in many other cases that he has brought against DAI.

3. While they were operating their store, and before this litigation began, defendants had filed with the Internal Revenue Service ("I.R.S.") a 1989 partnership tax return for their Subway store that showed that defendants had earned a $20,143 profit for their first ten months of operation. Defendant Nancy Kessler testified that this return was prepared by H&R Block based on defendants' Weekly Inventory Sales Reports ("WISRs"), contemporaneous store documents that accurately reflected the store's financial position.

4. Mr. Duree testified that, because he knew that this initial 1989 tax return would be a problem at trial since it was evidence that defendants' store was profitable, he made the "executive decision" for purposes of "trial strategy" to have Mr. Seiffert prepare and file with the I.R.S. an amended 1989 partnership return to show that defendants had suffered a loss in 1989. This amended return was prepared by Mr. Seiffert and filed with the I.R.S. in January, 1993, approximately four months before Mr. Duree filed the Counterclaim. The gross receipts on the amended return report only about one half the amount reported on the initial return, and the amended return showed the store operating a loss during 1989.

5. Although Ms. Kessler testified that only 50-60% of the store's receipts were deposited into any bank, Mr. Seiffert calculated the gross receipts reported on the amended return based on defendants' bank deposits. Mr. Seiffert attempted to justify his decision to rely on bank deposits by testifying that all defendants' WISRs for 1989 were not available, but at Mr. Seiffert's deposition Mr. Dunham quickly located in Mr. Seiffert's files all defendants' 1989 WISRs.

6. Mr. Seiffert appended to the amended return filed with the I.R.S. a disclaimer stating that "[w]e have prepared the 1989 Subway Limited income tax return from documents and information made available to us by the taxpayer. We are not able to determine whether this information supplied to us is complete and accurate."

7. Nevertheless, defendants, through Mr. Duree, tendered the amended return to the Court as an accurate and reliable document, and relied on it in opposing DAI's motion for summary judgment on the Counterclaim. Among other things, Mr. Duree submitted a sworn affidavit from Mr. Seiffert in which Mr. Seiffert criticized DAI's expert for relying on the initial return and averred that the amended return contained "the correct figures."

8. Based on the above findings, and all the other, overwhelming evidence submitted in connection with DAI's Motions, the Court has reached the inescapable conclusion that, in his role

as lead trial counsel, Mr. Duree deliberately caused to be prepared a false tax return for use in this litigation to support defendants' claims of fraud in the Counterclaim. Mr. Duree's conduct violates Model Rules of Professional Conduct 3.3, 3.4 and 8.4

9. The Court also finds that Mr. Duree caused the Counterclaim to be filed without any good faith basis in fact or law. In addition to the foregoing facts about Mr. Duree's knowing use of the false tax return, he had been defendants' lead counsel for two years when the Counterclaim was filed and knew or should have known that the true facts of the case did not support defendants' claims of fraud; the Court established the baselessness of these allegations when it granted summary judgment in DAI's favor on the entire Counterclaim. But Mr. Duree attempted to create a case where none existed by commissioning the preparation of the fraudulent amended tax return.

10. Moreover, the Court granted summary judgment based largely on the testimony of Ms. Kessler and Mr. Seiffert - information readily available to Mr. Duree well before he filed the Counterclaim - and concluded that the basic theory of defendants' case defies common sense. And, as the Court previously held at the August 8, 1995 hearing on DAI's April 25, 1995 Motion for Sanctions, defendants' counsel engaged in such bad faith in opposing summary judgment that it was clear that "the entire effort on the part of Mr. Duree and his associates was to divert the Court's attention from the facts of the case . . .

[that] were certainly not favorable to [defendants'] suit for fraud." If Mr. Duree had filed the Counterclaim in good faith with a reasonable basis in fact, he would not have resorted to such bad faith tactics in opposing summary judgment.

11. For the foregoing reasons, the Court concludes that Mr. Duree knowingly filed the Counterclaim without a reasonable basis in fact or law, and not in good faith. The Court also finds that all the attorney fees and costs that DAI incurred from the date of the filing of the Counterclaim through the Court's granting of summary judgment were directly caused by Mr. Duree's bad faith filing of the groundless Counterclaim, and that the $408,445.25 in fees and costs claimed by DAI is reasonable, given the amount of work involved in defending against defendants' baseless claims. The Court also notes that neither Mr. Duree nor anyone else acting on behalf of defendants has ever contested the reasonableness of these fees and costs.

12. Mr. Carter and Su Linda Jamison, defendants' local counsel, do not share Mr. Duree's culpability for the conduct listed above.

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED that DAI's Motion to Revoke Mr. Duree's *pro hac vice* admission is granted.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that DAI's Motion for Fees and Costs is granted, and Mr. Duree is ordered to pay DAI $408,445.25 to reimburse DAI for all the reasonable attorney fees and costs it incurred from the date the Fifth

Amended Counterclaim was filed through the date the Court granted summary judgment, because DAI incurred all these fees and costs as a result of Mr. Duree's knowing filing of the Fifth Amended Counterclaim without a reasonable basis in fact or law and not in good faith.

IT IS SO ORDERED.

Dated: July 19, 1996

/ss/ Janice D. Russell
Judge of the District Court

TRANSCRIPT OF PROCEEDINGS

BE IT REMEMBERED that on the 17th day of January, 1997 * * * before the HONORABLE LAWRENCE E. SHEPPARD * * *

As Mr. Dunham has pointed out several times in his oral argument, and clearly from the ruling Judge Russell made in removing Mr. Duree and sanctioning him with the costs that were taxed to him was an abuse of her judicial discretion, that particular subject is best tested by appeal. It should not be the responsibility of this Court, nor should this Court indulge the prerogative of reviewing another trial judge's discretionary ruling.

She lived with this case for some six years.

* * *

IN THE DISTRICT COURT
OF JOHNSON COUNTY, KANSAS
CIVIL COURT DEPARTMENT
DIVISION NO. 15

SUBWAY RESTAURANTS, INC.,
SUBWAY EQUIPMENT LEASING CORP.
and DOCTOR'S ASSOCIATES, INC.,

Plaintiffs,

vs. Case No. 90C12370

NANCY KESSLER and DANE BANKS,

Defendants.

July 8, 1997
TRANSCRIPT OF PROCEEDINGS

* * *

JUDGE SHEPPARD: Excuse me, sir. That's the one that I ruled on and indicated I would not independently exercise my discretion to review the ruling of Judge Russell

MR. DUNHAM: That's correct. And you also incorporated by reference the other arguments that we had made. You denied that motion from the bench on January 17th.

* * *

JUDGE JANICE RUSSELL
DIRECTION EXAMINATION BY MR. LANCASTER

Q. Would you please state your name and occupation.

A. I'm Janice D. Russell. I am a judge of the District Court, Johnson County, Kansas.

Q. And, Judge Russell, you were the judge originally assigned to the Subway Restaurants, Inc. v. Kessler and Banks that we're here on today; is that correct?

A. That is correct.

Q. In the spring of 1995, you had before you the parties' briefs and selected excerpts from their testimony in support of and opposition to the plaintiffs' motion for summary judgment on the defendants' counterclaim, the Banks and Kessler counterclaim; isn't that true?

A. That's correct.

Q. And from your review of those depositions and excerpts, you concluded that the defendant - the defendants had kept such poor business records that they would never have been able to sustain at trial their burden of proof on the issue of causation between the alleged fraud and their alleged damages; isn't that also true?

A. I think that's a fair summary of my opinion.

Q. Okay. I'm just trying to ask a few background questions, and I'll move into the relevant areas very quickly.

During the work on the motion for summary judgment, you had suspected from the fact pattern you saw that it looked like that perhaps the defendants might be taking money out of the till to support a drug habit, but there was no evidence - that issue didn't come out initially, but you suspected it was there anyway, did you not?

A. That was in the back of my mind, yes.

Q. Okay.

A. But that was not one of the bases for my opinion, and it didn't come into my decision in any way.

Q. In the summary judgment?

A. That's right.

* * *

Q. Okay. Now, in late 1995 - October, November - the plaintiff, which is did a DAI - Doctor's Associates - represented by Mr. Dunham, filed two motions. One was to enter a sanction against Mr. Duree, the other was to revoke his pro hac vice admission before this Court.

A. Yes.

Q. And that was actually after this came up, after the motion for summary judgment, and you granted it on the counterclaim.

A. Yes.

Q. Okay. Now, you heard oral argument on these motions which were the subject of your May 31 memoranda decision in March and April of 1996, and then you had taken them under advisement; is that correct?

A. That's correct.

Q. All right. Now, on May the 24th of 1996, you were working on either a completed or you were about to complete your memoranda opinion on the motion for sanctions and the motion to revoke Mr. Duree's pro hac vice admission.

A. Yes.

Q. Okay. And from your deposition testimony, we know that that was probably a Friday, Mr. John Gerstle, an old friend of yours, dropped by your office, and you had a conversation with him on that occasion, on May 24th -

A. That's right.

Q. -- of '96.

Could you relate to the Court what Mr. Gerstle said to you and what you said to Mr. Gerstle on the occasion of this conversation?

A. Well, I had been working on this opinion all day on Friday the 24th of May and probably part of the day on May 23rd, too, although I don't specifically recollect that. I do

see from my '96 calendar that the hearings that were set for both of those days canceled out, so I probably devoted both of those day to working on this issue.

Late Friday afternoon - it was after 4:30, I'm sure - John Gerstle stopped by my office and said - and asked me if I wanted to go out and have a beer. And I told him that I was working on something, that I was within a few sentences of being done with it and when I finished, I would do that. He said, "Well, what are you working on?" And I said, "Well, it's one of my civil cases. You don't know anything about it." And he persisted and said, "Well, no, what are you working on?" And I said, "Well, it's a case called Subway versus Kessler and Banks, and you don't know anything about it. Never been an attorney in the case, you don't know anything about this." And he said, "Oh, I do know about that case." And I said, "How would you know anything about this? You've not been counsel in this case." And he said, "Oh, I know a great deal about this case." He said, "I represented Nancy Kessler." And I knew he didn't represent her in this case. He had never entered an appearance in my case in any fashion. I said - because I had harbored these suspicions that there was a cocaine problem there, and because I knew Gerstle had a largely criminal practice, and, in fact, represents a lot of drug defendants, I said, "Cocaine?" And he said, "Oh, yeah.

Big time." I said, "Well, that doesn't have anything to do with this issue." And he said, "Well, I know" - he said, "Well, what are you doing?" And I said, "There's a motion for sanctions against Mr. Duree." He said, "Mr. Duree is a great guy. He's a really nice guy. He paid my fees to represent Nancy Kessler." And that was, I think the extent of the conversation.

Q. From that conversation and from other things that you had heard, you reached certain conclusion at that point in time, May the 24th, about Mr. Duree and certain things. Would you recount - let me just see if I can do it this way.

A. Okay.

Q. You assumed from that conversation that Nancy Kessler was a client of Mr. Gerstle's on some drug charge.

A. I did assume that.

Q. Okay. And you assumed further that David Duree knew about Nancy Kessler's drug problem.

A. I assumed that.

Q. And you further assumed that David Duree knew that Nancy Kessler was taking money from the till of the Subway shop to support her drug habit.

A. Yes, I assumed that.

* * *

Q. Was there - did you conclude something or surmise something about a relationship between the drug use and the filing of the amended tax return?

A. Yes.

Q. And what was that?

A. My surmise was that Mr. Duree, in fact, knew of Nancy Kessler's drug problems, that that would have given him a pretty good clue about why this business went under, about why money was being taken out of the till, and that the filing of the amended return - I didn't think it was done to cover up the fact that money was taken out of the till or that it was done to cover her drug problem, but I assumed that he knew that money was being taken out of the till for some purpose other than the business; and that, in part, the filing of the amended tax return had the effect of not covering that up, necessarily, but certainly making it more difficult to discern.

* * *

Q. And is your testimony, then, that you don't think that the filing of the amended return had anything to do with the - his knowledge of her drug use and taking money of the till?

A. I don't know how to answer that.

I think he had the amended '89 tax return prepared as a matter of trial strategy. The purpose for preparing that tax return was an attempt to show that their business had operated at a loss; and whether or not he wanted to, in addition, cover up drug problems is something I can't answer.

MR. LANCASTER: Let me - could I approach, Your Honor?

MR. DUNHAM: What page and line please?

Q. (By Mr. Lancaster) Let me hand you, Judge Russell, a transcript of your deposition taken on July the 2nd, Page 40, starting at Line 8, and ask if you would just look at that for a moment.

Starting at Line 8, question by me, "But that was your surmise, that the decision to file the amended tax return was tied to his knowledge of her cocaine problem?"

Answer at Line 12, "Yes, that was my surmise."

Is that an accurate statement?

* * *

A. Yes, that's the -

* * *

Q. Did you also surmise that Mr. Dunham - I'm sorry, strike that - that Mr.

Duree, David Duree, had hired - from that conversation with John Gerstle, that Mr. Duree had hired Mr. Gerstle to cover up this - to get rid of this cocaine problem with Nancy Kessler?

A. That would have been my guess.

Q. I beg your pardon?

A. That would have been my guess.

Q. All right.

Now, on May the 31st of 1996, a week later, you filed your memoranda decision sanctioning David Duree $408,000 and change and an order revoking his admission pro hac vice, did you not?

A. Yes, I did.

Q. Now, on November the 8th of 1996, there was a hearing scheduled before you.

JUDGE SHEPPARD: What was the date, sir?

MR. LANCASTER: November the 8th, 1996.

Q. (By Mr. Lancaster) - there was a hearing scheduled before you to - which I had filed on behalf of Mr. Duree to reconsider your decision.

A. That's right.

Q. And at that - right just immediately prior to the hearing, you called the

counsel to your chambers, including Mr. Dunham and myself, and advised that - advised us that you had had an ex parte communication with someone, and because of that ex parte communication you did not feel you could be impartial and couldn't give Mr. Duree a fair hearing, and that it was appropriate at that point in time for you to recuse yourself.

A. Yes.

Q. Is that an accurate statement of what happened?

A. Yes.

Q. And the basis for your decision that you made on November the 8th that you couldn't be impartial was the conclusion that you reached back at the time of this discussion with Mr. Gerstle that David Duree knew about Nancy Kessler's cocaine habit, he knew she was taking money out of the business to support her habit, that that was part of the basis for her deciding to amend the '89 tax return, and that was his basis for hiring Mr. Gerstle was to cover this up.

All of these facts caused you to feel you couldn't be an impartial hearer of the facts, if you will; isn't that true?

A. Yes.

Q. Okay.

A. I could not set that conversation with John Gerstle out of my mind. I found it impossible to separate that from the issues that I was called upon to decide on that day, and I therefore thought it was appropriate for me to recuse myself.

* * *

Q. Now, these circumstances that caused to you recuse yourself on November the 8th of 1996 existed - the same set of circumstances existed on May the 31st of 1996, when you filed the memoranda opinion in this case; isn't that true?

A. That is true.

Q. And the same circumstances that caused you to recuse yourself on November 8th, 1996, existed on July 19th of 1996 at the hearing to settle the dispute over the journal entry from your May 31st, 1996, memoranda opinion?

A. That's true.

Q. Okay. The journal entry - let me, if I could approach.

A. You can approach.

Q. Thank you.

If I could hand to you what has been marked as Respondent's Exhibit 1 and 2, if you would just identify those for the record. There are some

markings on them that we'll get to later, but -

A. Exhibit 1 is the memorandum opinion that was filed on May 31st and was prepared on May 24th.

Q. Okay.

A. Exhibit No. 2 is the journal entry which makes that memorandum opinion an order of the Court.

Q. That's the one that you signed on July 19th?

A. Yes.

Q. Okay. Now, that journal entry, Exhibit No. 2, is a journal entry that Mr. Dunham prepared for your consideration because of strong objections to that journal entry from Mr. Duree's counsel; is that not true?

* * *

A. You know, I think I told you in the deposition, I don't have a very clear recollection of what happened at that July 19th hearing. I know there was a dispute over the form of the journal entry.

Q. (By Mr. Lancaster) Okay.

A. And I heard the parties and made a decision about which journal entry to sign.

Q. Okay.

If you would look on Exhibit 2, a number of the findings of fact and conclusions of law contained in that journal entry, particularly - let me look at it just a second.

MR. LANCASTER: Here's a copy, Your Honor. (Counsel handed a document to the Court.)

Q. (By Mr. Lancaster) Starting on page 3 and the entirety of the Paragraphs 9, 10 and 11 in that journal entry are underlined, in addition to other findings. Do you see that, Your Honor?

A. You said -

JUDGE SHEPPARD: Beginning at Paragraph 9 on Page 4.

MR. LANCASTER: The first underlining is on Paragraph 4 on Page -

JUDGE SHEPPARD: You see that?

JUDGE RUSSELL: Yes.

Q. (By Mr. Lancaster) And part of Paragraph 8 on Page 4 and then the entirety of Paragraphs 9, 10, and 11 on Page 5. Do you see those?

A. Uh-huh. Yes, I do. I'm sorry.

Q. Now -

JUDGE SHEPPARD: Who did the underlining?

MR. LANCASTER: I did the underlining.

Q. (By Mr. Lancaster) I have underlined those portions of the journal entry, Judge Russell. And would you agree with me that if what I have underlined in Exhibit 2 represents findings of fact and conclusions of law not found in Exhibit 1, your memoranda opinion, that there was a substantial modification of the judgment entered in this case from the time of your opinion until the time you signed your journal entry?

A. If you are correct that all of this is new and is not contained in my memorandum opinion, then, yes, you are correct. But although this may be worded differently than my memorandum opinion words the findings, I think that all of this is fairly encompassed within my memorandum opinion.

Q. What if none of it is encompassed within your memorandum opinion?

MR. DUNHAM: Object to the form, Your Honor, because I think it's also been asked and answered.

JUDGE SHEPPARD: Well, it's clearly argumentative, and I'm sure the judge can answer the question.

A. I think that - I think that this - the language that appears on Page - Pages 4, 5 and 6 is a pretty fair summary of what I said in the

memorandum opinion. And it it's not said, it's what I meant.

* * *

JOHN P. GERSTLE
DIRECT EXAMINATION BY MR. LANCASTER

Q. Would you please state your name and current occupation.

A. John P. Gerstle. I'm an attorney in Overland Park, Kansas.

Q. And do you know the Honorable Jan Russell?

A. I do.

Q. How long have you known Judge Russell?

A. Give or take twenty years or more.

Q. All right. Have you had occasion to have a conversation with Judge Russell regarding your representation of Nancy Kessler?

A. Yes.

Q. And where did that conversation take place?

A. It took place in her chambers, Division 7, and I think it was in the current location of her court now, so that would be on the third floor.

* * *

Q. Okay. Now, the - was there only one conversation with Judge Russell regarding Nancy - your representation of Nancy Kessler, or was there more than one?

A. My best recollection is there was one, because after we were talking for a bit, it occurred to Judge Russell that since she was involved in the case, maybe it would be inappropriate to continue talking about them.

Q. Okay. When did you next - what was your next contact regarding that conversation with anyone?

A. Well, it was with yourself and with opposing counsel, all at about the same time. And I want to say that time frame would be October or November of 1996.

Q. And in that - at least I called you by phone, did I not?

A. Yes.

Q. All right. And asked you about the conversation with Judge Russell?

A. Yes.

Q. And this is - did you - did I ask you when you believe that conversation occurred?

A. Yes.

Q. And what did you tell me?

A. My initial belief was I believe that it was in 1995. The reason that I felt that way at that time - and keep in mind I hadn't thought about the conversation until that day, because I believe I had been contacted by both sides that day, and if not that day, very close to one another in time, and I had not even looked at my file. In fact, I wasn't sure if my file was near at hand or whether it was in my - in the archives, away from the office from where I was. So I was operating on memory at that point. And I generally have a pretty good memory. And the fact that there seemed to be some indication that the conversation could have occurred in late May of 1996, my gut reaction was that probably not, because that would have only been four to five months earlier, and it would seem to me that I would have had a better memory of something that recent. So my best recollection at that time was that it probably occurred in 1995.

* * *

CROSS EXAMINATION
BY MR. DUNHAM

Q. You recall, Mr. Gerstle - and again I'm not looking for a verbatim transcript, but, in substance, I told you when I prepare witnesses to testify, I say I've got this scale from zero to ten, and if you're just at five, in the middle of the scale, that you're really just guessing and you therefore shouldn't testify under oath?

A. Yes.

Q. And you recall that when you and I were having that exchange as lawyers, you told me in substance that essentially you would just be guessing in trying to pin down when the conversation with Judge Russell actually happened?

A. Yes.

Q. And in the telephone conversation with Mr. Wilkins you also recall saying to Stan and me, or words in substance, "I do not recall when this discussion took place and I cannot remember the year or even the season when the discussion took place"?

A. That's accurate.

Q. And that was the truth when you told me that, wasn't it, Mr. Gerstle?

A. Yes.

* * *

REDIRECT EXAMINATION
BY MR. LANCASTER

Q. Mr. Gerstle, I think the point that Mr. Dunham is trying to get at is that he believes there's an inconsistency between the statement that you just made that you can't remember the date, season, year in the affidavit you signed and previously affirmed earlier in this testimony. Could you explain to the

Court whether there is - if you believe there is an inconsistency in those statements by yourself?

A. I do not believe there's an inconsistency. I, too, am an officer of the Court, and this affidavit is given under oath, as was my deposition. I would not swear or sign to anything that was not true. And I do not find that document to be at variance with any other document that I signed that has my name on it. This simply says different things surrounding the same subject matter. When I swear to something, I want to be dead-on sure of it. And if I'm not dead-on sure of it, I am going to say I'm not. And whatever words you choose to have me sign that meet that intent, I am going to sign it. Same thing as was proffered to me by opposing counsel. There is nothing, in my mind, between those two affidavits that is substantially at variance.

Now, you can argue the semantics of it and the degrees and whatnot. My intent is real clear. I believed that the conversation occurred in 1995. It could have occurred in 1996. I have no way to definitively mark in my mind when it occurred. I am using information given to me by counsel in this case. I am referring to information from Judge Russell that has been provided to me secondhand or thirdhand. I would never dispute Judge Russell. However, I cannot sit here and tell you that if my life depended on it I

would swear that it occurred on a date certain - on a date in a year certain. I cannot and will not do that. My believe is as I stated, probably in 1995, but I can't say for certain the season, whatever. That's why I signed both documents, because, in my mind, they're both saying the same thing. They both say the same thing; they're just coming from a slightly different direction.

* * *

JUDGE SHEPPARD: Thank you very much.

The Court's prepared to give you a ruling on this, and then if we still have time we'll take up the other matter that was reserved as the sanctions.

First of all, this Court recognizes the gravity of the allegations that are made by the non-party Duree's motion to set aside the Court's May 31st, 1996, memorandum opinion and the July 19, 1996, journal entry.

The Court, contrary to the statements of Mr. Dunham, does not find the Motion No. 2 to be frivolous. I find it to be unnecessary, but I don't find it to be frivolous. Had the motion that was Motion No. 1 been pled to include the allegations that are part of this particular motion which set out the conversation between Judge Russell and Mr. Gerstle, and had the matter

been properly noticed for hearing on January the 17th, I would have heard everything at that time or over a period of time to allow the record to be developed. So from the Court's standpoint, this particular proceeding this afternoon is something that could have been at least initiated on January 17th. But it is not frivolous. It raises very serious issues with respect to the conduct of attorney John P. Gerstle and also reflects on Judge Russell's decision.

I want to make it very clear, this is not a disciplinary proceeding involving either one of them. What I'm concerned with is the responsibility to rule on this motion as the judge who has succeeded to the responsibility for the Subway vs. Kessler case.

In doing so, I would adopt the earlier remarks I made in ruling on Motion No. 1 and emphasize that with respect to the decision that Judge Russell announced by way of written memorandum decision dated May 31st, 1996, she had lived with this case for five years preceding the moment at which - and as a matter of fact, the motion for sanctions that the plaintiff's counsel had filed was pending at least from October of '95 until May 31st of '96, when she delivered her written decision. And so she obviously had deliberated with measured thoughts the motion with the benefit of the preceding litigation prior to October of '95,

and with all of the subsequent events involving briefing and oral argument that gave her more information from which she ultimately rendered her decision.

The worst thing that the Court can observe about the casual meeting of Mr. Gerstle and Judge Russell late in the afternoon of May 31st, 1996, is the appearance that a jurist allowed herself to engage in a conversation ex parte with an attorney that tainted a decision that she had already made. And I'm quite satisfied from listening to her testimony under oath that her decision was not influenced by the conversation with Mr. Gerstle. She had, as I just noted for the record, some nearly five years or so of experience with the case that allowed her to reach the conclusions that she did, as stated in her memorandum decision of May 31st, 1996.

But the Court, having heard now arguments of counsel, would, at Mr. Lancaster's request, apply to this particular civil ruling that of a reasonable person, the standard of a reasonable person and not one that might otherwise apply in a disciplinary proceeding where you might be concerned more with the propriety of the circumstances than with the legality of the ruling.

Mr. Lancaster, I invite to you again cite me to the portion of the your brief.

MR LANCASTER: Page 19 of our brief.

JUDGE SHEPPARD: Thank you.

I'm also mindful of Mr. Dunham's quotes from State v. Alderson. But the Court, in considering this, takes the position of what a reasonable person would suspect that the Court's opinion on the merits was based upon.

In listening to her testimony, first of all, I believe Judge Russell's testimony, not because she's a colleague and a fellow jurist, but because she testified under oath forthrightly, without hesitation, with obvious knowledge of the facts, and in a most unusual proceeding which allowed counsel to go into her subjective thought process as to how she arrived at her decision. She was most candid in that regard and unequivocating in terms of the examination by both counsel. She clearly had firm reasons, as set forth in her memorandum decision, for making the ruling of sanctions as to David Duree and her revocation of Mr. Duree's pro hac vice status in this particular case.

The Court, then, finds that a reasonable person would believe, based upon the testimony of Judge Russell, that there was no influence or bias on her part with respect to the decision that was filed. It was a measured decision that she reached only after hearing the evidence in

the case from the trial record and from all of the preceding proceedings.

With regard to attorney Gerstle's testimony, the Court observes that Mr. Gerstle testified in earnest that he did not have an independent recollection, short of that provided by counsel, as to when this conversation occurred. His earliest statement was it occurred in 1995. The Court believes that that is probably the most creditable recollection, was the initial statement, and that over time he continues as he did here and under deposition by Mr. Dunham to acknowledge that he does not recall when he talked with Judge Russell and he cannot remember the year or even the season when the discussion took place.

The timing of the discussion is important because of the poor timing of the discussion. Had it occurred the day after filing of the memorandum decision, there would have been no real reason or opportunity to complain about the substance of the ruling. As it is, the timing was absolutely terrible in terms of eroding confidence in the independent exercise of judgment on the part of Judge Russell.

However, as the succeeding judge who is called upon to rule on the succeeding motion, the occurrence does not cause me, in applying a reasonable person's standard, to find

that a reasonable person would believe other than that Judge Russell made a deliberate, considered ruling without bias, without prejudice, and that David Duree's instant motion should be and is denied for those reasons.

IN THE SUPREME COURT OF THE STATE OF KANSAS

Nos. 78,907 and 79,740

SUBWAY RESTAURANTS, INC., *et al.*,
Appellees,

v.

NANCY KESSLER and DANE BANKS, *Defendants,*
and DAVID M. DUREE,
Appellant.

SYLLABUS BY THE COURT

In a non-admitted attorney's appeal from a K.S.A. 60-2007(b) monetary sanction and revocation of the attorney's *pro hac vice* admission to practice, the record is examined and it is held: (1) The sanctioned attorney was not denied due process of law, (2) a judge's ex parte conversation with a nonparty attorney referencing the sanctioned attorney occurring before the memorandum opinion ordering sanctions was issued was improper but does not require reversal, (3) the record reflects substantial competent evidence to support the imposition of sanctions and revocation of the *pro hac vice* admission, and (4) denial of the sanctioned attorney's K.S.A. 60-259(f) motion to alter or amend by a judge to whom the motion was assigned after the judge imposing the sanctions recused herself was not an abuse of discretion.

Appeal from Johnson district court. JANICE D. RUSSELL and LAWRENCE E. SHEPPARD, judges. Opinion filed December 18, 1998. Affirmed.

Douglas Lancaster, of Overland Park, argued the cause, and *Greer S. Lang*, of Lawrence, was with him on the briefs for appellant.

Edward W. Dunham, of Wiggin and Dana, of New Haven, Connecticut, argued the cause, and *Stanley N. Wilkins*, of Turner and Boisseau, Chartered, of Overland Park, was with him on the brief for appellees.

The opinion of the court was delivered by

SIX, J.: This is a K.S.A. 60-2007(b) attorney sanctions case. David M. Duree's *pro hac vice* admission to practice in Kansas was revoked and he was ordered to pay plaintiff Subway/Doctor's Associates, Inc., (DAI) $408,445.25 by District Judge Janice D. Russell. Judge Russell found that Duree deliberate directed the preparation of a false 1989 partnership tax return to support is clients' fraud counterclaims. Judge Lawrence E. Sheppard, after Judge Russell recused herself, denied Duree's K.S.A. 60-259(f) motion to alter or amend, refusing to set aside Judge Russell's order. Duree appeals from the rulings of both judges.

Our jurisdiction is under K.S.A. 20-3018(c), a transfer on our own motion.

We consider two issues: (1) Was Duree denied due process by the circumstances surrounding Judge Russell's recusal, and (2) was there substantial competent evidence to support Judge Russell's imposition of sanctions and revocation of Duree's *pro hac vice* admission? Finding no error, we affirm.

FACTS

A review of the facts in the underlying lawsuit is necessary to provide background as Duree's objections to the sanctions unfold in this appeal. Defendants in the underlying lawsuit, Nancy Kessler and Dane Banks, contracted with DAI, the national franchisor of Subway sandwich shops, to become a Subway franchisee in Olathe. Kessler and Banks borrowed to finance construction and start-up. They immediately began to pay personal expenses from the borrowed funds, leaving the shop short of the estimated start-up costs.

Lack of operating funds became an immediate problem. Kessler and Banks had seven different checking accounts at four different banks during their 19 months of operation. They bounced 224 checks and failed to deposit at least $112,219.38 in cash receipts during the first 13 months. As a result, the Subway shop's bank statements did not accurately reflect performance. The most accurate documents reflecting performance were Weekly Inventory and Sales Reports (WISR's). DAI requires all franchisees to produce WISR's. Kessler receive WISR training. She testified: (1) the forms were simple to fill out, and (2) the WISR's she filed out were accurate. Kessler and Banks used the WISR's in the shop's original tax return prepared September 1990 by H&R Block. The original return showed gross receipts of $139,369 and a profit of $20,143 for the first 8 1/2 months of operation. The figures in the original return were primarily from the WISR's.

DAI filed a collection action against Kessler and Banks in 1990 seeking to recover unpaid franchise royalties and arrearages on a real estate sublease and an equipment lease. Kansas counsel for Kessler and Banks filed a counterclaim in February 1991. Duree was hired sometime in the summer of 1991. Matters against DAI accounted for about 20% of Duree's practice. Judge Russell admitted Duree *pro hac vice*. (Duree is admitted to practice law in Missouri and Illinois.) He assumed the role as lead counsel. Kessler and Banks' series of five amended counterclaims alleging various claims, including fraud and punitive damages, commenced. The fifth amended counterclaim, central to this appeal, contained 47 allegations of fraud and a claim for punitive damages. Kessler and Banks contended that DAI had fraudulently induced them into purchasing a Subway franchise doomed to fail because of a poor location and a lack of promised operational support.

Duree drafted the fifth amended counterclaim. Before filing, he decided to have an amended 1989 tax return prepared for the Subway shop. Duree hired Robert Seiffert, a CPA, from St. Louis. (Duree used Seiffert as an expert in five other cases against DAI.) They were personal friends and had a close working relationship, especially on Subway shop matters. Both Duree and Seiffert knew of the existence, use, and purpose of the shop's WISR's.

Seiffert was given all of the shop's financial documentation, including the WISR's, *but he prepared the amended return*

using only bank records. The 1989 amended return reported a loss based on gross receipts of $71,543, compared with $139,369 on the original return. Kessler testified that she and Banks failed to deposit at least half of their cash receipts in the bank. Seiffert also admitted later in his deposition that the bank deposits "for sure understate[d] gross receipts." Seiffert attached a disclaimer to the amended return stating: "We are not able to determine whether this information supplied to us is complete and accurate." (He had been involved in the preparation of between 200 to 400 tax returns but could recall using such a disclaimer on only one or two other returns.)

Intensive and hard-fought discovery continued for the next 2 years. Duree, his co-counsel, and his clients were sanctioned $1,000 for discovery abuse by the special master appointed by Judge Russell to conduct discovery.

DAI submitted 267 statements of uncontroverted fact to support its motion for summary judgment on the fifth amended counterclaim. DAI argued that the reason Kessler and Banks failed in their business was not because of any misrepresentations made by DAI, but because of their own mismanagement. Most of the uncontroverted facts submitted by DAI came directly from either Kessler's deposition or the franchise agreement.

Kessler and Banks' response to DAI's summary judgment motion: (1) contained many accusations of unethical conduct by DAI, (2) did not comply with Rule 141(b)

(1998 Kan. Ct. R. Annot. 176), (3) failed to controvert many of DAI's statements of uncontroverted facts, and instead objected on the grounds of relevancy, materiality, or that the fact was misleading, and (4) moved for sanctions against DAI's counsel Edward Dunham. (Duree later withdrew the motion for sanctions against Dunham.)

In support of the request for sanctions against Dunham, Duree submitted an affidavit from Seiffert. Seiffert repeatedly attempted to controvert facts regarding the shop's losses by pointing to the 1989 amended tax return. DAI had ignored the amended return because the copy provided during discovery was neither signed nor dated and did not appear to have been filed. Seiffert's affidavit claimed that the amended return contained the "correct figures" and that DAI had attempted to mislead the court by relying on the original return.

After reading Seiffert's affidavit, DAI realized Duree was relying on the amended return to support the claim that the Subway shop lost money. Seiffert's claim that DAI had relied on the wrong tax return was questioned at the summary judgment hearing. Seiffert testified in his deposition that he did not know if the amended return had been filed. (His deposition was taken before his sworn affidavit.) Judge Russell then questioned Duree about the amended return. Duree said that he did not know whether the return had been filed, calling it an "evidentiary detail." Judge Russell responded, "I guess it disturbs me, though, that you are attacking another attorney's ethics based upon a tax return

that you can't tell me if it has been signed or filed. That disturbs me." Judge Russell was compelled to call a recess so that Duree and local counsel could confer and try to "get their story straight." After the hearing, it was still unclear whether the amended return had been filed. Counsel for DAI pursued the matter. DAI's motion to reopen discovery as to the 1989 amended return was granted.

Meanwhile, Judge Russell issued her opinion granting summary judgment in favor of DAI on Kessler and Banks' fifth amended counterclaim. She found the counterclaim totally without merit, stating: "It is not just that [defendants] cannot sustain their burden of proving the falsity of these statements; they have no proof whatsoever."

The Court of Appeals affirmed Judge Russell's decision, citing her "thorough and careful examination" of a voluminous record, and characterizing her analysis of the uncontroverted facts as "disciplined." *Subway Restaurants, Inc. v. Kessler*, No. 75,053, unpublished opinion filed February 21, 1997, *rev. denied*, 262 Kan. ____ (1997).

The Sanctions Hearings

Judge Russell held an evidentiary hearing on various motions for sanctions against Duree related to the summary judgment response. After a lengthy proceeding, she imposed a $5,250 monetary sanction against Duree and his co-counsel. Judge Russell found the accusations of impropriety against DAI were unfounded and

an attempt to "divert [the court's] attention from the facts of the case." Duree sidestepped the issue of the 1989 amended tax return, professing ignorance and characterizing the issue as a document production dispute. Judge Russell expressly reserved the question of whether further sanctions would be imposed with respect to the amended 1989 tax return.

Additional discovery commenced. Duree testified that he had in fact directed Seiffert to prepare the 1989 amended return *"on the basis of trial strategy" so that Duree would not be "arguing to some jury and/or judge that the original tax return didn't accurately reflect their financial condition.... [C]ase management was my primary objective."* Duree knew the contents of the original return and acknowledged that the original return showed a profit, which was inconsistent with his theory of the case.

Seiffert admitted that he based the amended return on bank deposits and not on the WISR's. The bank deposits understated both gross receipts and revenues. Seiffert had the WISR's in his possession when preparing the amended return. He knew their purpose, but ignored them in his calculations.

Kessler and Banks' local counsel, Su Linda Jamison, had Banks sign the amended return, which she filed with the IRS in January, 1993. Ms. Jamison remained silent in Judge Russell's courtroom as Duree professed he did not know whether the amended return had been filed.

DAI moved to sanction Duree and his co-counsel Carter under K.S.A. 60-2007(b) and K.S.A. 60-211. DAI asked the district court to assess $408,445.25, the fees and costs incurred from the date Duree filed Kessler and Banks' fifth counterclaim until the grant of summary judgment, more than 2 years later. DAI submitted affidavits from Ned Allen Ford, Distinguished Professor of Accountancy at Kansas University, and Geoffrey C. Hazard, Jr., Professor of Law at the University of Pennsylvania. The affidavits supported DAI's claim that Duree had asserted the Kessler-Banks fraud claims in bad faith. Professors Ford and Hazard criticized the actions of Seiffert and Duree. Professor Hazard concluded that Duree "[c]onceived, directed and executed a plan whereby a false document, consisting of a falsified Federal Income Tax return, was prepared for introduction into evidence before [Judge Russell's] court as evidence that his clients suffered economic loss, knowing that such proof was false and that it would mislead the Court and jury." Hazard also concluded that Duree's conduct "justifie[d] the most severe professional sanctions."

Duree vigorously opposed DAI's submissions. Professor Hazard was deposed. Duree moved to strike Hazard's affidavit arguing he was not a tax expert and his testimony was purchased by DAI. Duree submitted his own 17-page affidavit, swearing: "There is nothing wrong with the Amended 1989 Partnership Tax Return."

On March 8, and April 16, 1996, Judge Russell held hearings on DAI's motion for further sanctions and revocation of

Duree's *pro hac vice* status. Hazard testified. Duree's expert was attorney John Nicholas Badgerow, chairman of the Johnson County Bar Association Ethics and Grievance Committee. Badgerow criticized Hazard's opinion that Duree had violated the Model Rules of Professional Conduct (MRPC), because that opinion is reserved for the disciplinary committee and this court. Badgerow offered no opinion about whether Duree acted unethically. Judge Russell allowed Duree to take the stand and testify in narrative form.

At the conclusion of Hazard's, Badgerow's, and Duree's testimony, Judge Russell said, "I regard this as a very serious matter, and I want to review a number of documents and pleadings before I make a decision in the matter, so I'll be taking it under advisement."

The Gerstle Visit

As Judge Russell was in her chambers finishing the memorandum decision on DAI's motion for sanctions, attorney John Gerstle, an old friend, stopped by.

Judge Russell described the visit in her testimony before Judge Sheppard:

> "Well, I had been working on this opinion all day on Friday the 24th of May and probably part of the day on May 23rd, too, although I don't specifically recollect that. .
> .
>
> Late Friday afternoon - it was after 4:30, I'm sure - John

Gerstle stopped by my office and said - and asked me if I wanted to go out and have a beer. And I told him that I was working on something, that I was within a few sentences of being done with it and when I finished, I would do that. He said, 'Well, what are you working on?' And I said, 'Well, it's one of my civil cases. You don't know anything about it.' And he persisted and said, 'Well, no, what are you working on?' And I said, 'Well, it's a case called Subway versus Kessler and Banks, and you don't know anything about it. Never been an attorney in the case, you don't know anything about this.' And he said, 'Oh, I do know about that case.' And I said, 'How would you know anything about this? You've not been counsel in this case.' He said, 'I represented Nancy Kessler.' And I knew he didn't represent her in this case. He had never entered an appearance in my case in any fashion. I said - because I had harbored these suspicions that there was a cocaine problem there, and because I knew Gerstle had a largely criminal practice, and, in fact, represents a lot of drug defendants, I said, 'cocaine?' And he said, 'Oh, yeah. Big time.' I said, 'Well, that doesn't have anything to do with this

> issue.' And he said, 'Well, I know' - he said, 'Well, what are you doing?' And I said, 'There's a motion for sanctions against Mr. Duree.' He said, 'Mr. Duree is a great guy. He's a really nice guy. He paid my fees to represent Nancy Kessler.' And that was, I think the extent of the conversation."

Judge Russell issued her sanction opinion 1 week later. Duree then moved to alter or amend under K.S.A. 60-259(f). Judge Russell informed counsel just before beginning the hearing on the motion that she had decided to recuse herself because of an ex parte conversation. She was concerned about her continuing objectivity. The pending motions were reassigned to Judge Lawrence E. Sheppard. Counsel for Duree and DAI jointly requested that Judge Russell provide more information about the ex parte conversation. She agreed. According to Judge Russell, Gerstle's stopping by her chambers was not unusual. He is someone she knows well. Gerstle testified he did not remember "precisely what we talked about or how we got into the subject matter." He further testified that after they were "talking for a bit, it occurred to Judge Russell that since she was involved in the case, maybe it would be inappropriate to continue talking about [it]."

Judge Sheppard's Rulings

Judge Sheppard denied the K.S.A. 60-259(f) motion, but later, upon a second

amended motion, conducted a full evidentiary hearing. Judge Russell testified that the conversation with Gerstle had not influenced her decision. According to Judge Russell, not only had she already made her decision at the time of the Gerstle visit, but also, "[t]he opinion, apart from perhaps the last paragraph, was already in the computer." She said, referencing the hearing on Duree's motion to alter or amend: "I found it impossible to separate [the conversation with Gerstle] from the issues that I was called upon to decide on that day, and I therefore thought it was appropriate for me to recuse myself." Judge Russell testified that she was not "feeling any hostile feeling or ill will toward Mr. Duree" at the time she made her decision to sanction him.

Judge Sheppard upheld Judge Russell's decision, reasoning:

> "In listening to her testimony, first of all, I believe Judge Russell's testimony, not because she's a colleague and a fellow jurist, but because she testified under oath forthrightly, without hesitation, and with obvious knowledge of the facts, and in a most unusual proceeding which allowed counsel to go into her subjective thought process as to how she arrived at her decision. She was most candid in that regard and unequivocating in terms of the examination by both counsel. She clearly had firm reasons,

> as set forth in her memorandum decision, for making the ruling of sanctions as to David Duree and her revocation of Mr. Duree's pro hac vice status in this particular case.
>
> The Court, then, finds that a reasonable person would believe, based upon the testimony of Judge Russell, that there was no influence or bias on her part with respect to the decision that was filed. It was a measured decision that she reached only after hearing the evidence in the case from the trial record and from all of the preceding proceedings."

DISCUSSION

Due Process

We initially review Judge Sheppard's denial of Duree's K.S.A. 60-259(f) motion to alter and amend. Our standard of review is abuse of discretion. See *Webber v. Mefford*, 43 F.3d 1340, 1345 (10th Cir. 1994); 11 Wright & Miller, *Federal Practice and Procedure*, § 2818 (abuse of discretion is well-settled standard of review on motion to alter or amend). Duree claims that Judge Russell's failure to recuse herself immediately after the ex parte communication with Gerstle denied him due process. Specifically, he claims:

> "Judge Russell's ex parte communication with Gerstle and her admitted inability

> to be fair and impartial, as well as her admitted inability to separate her extrajudicial knowledge from the issues she was being asked to decide, unquestionably influenced her in deciding DAI's motions for sanctions and to revoke Duree's pro hac vice admission and deprived Duree of his right to have these most serious allegations of misconduct decided by a fair and impartial court."

Duree's due process claim lacks merit. Throughout his brief, Duree misstates the record and misconstrues Judge Russell's testimony about the ex parte conversation. Judge Russell admitted neither an inability to be fair and impartial nor an inability to separate extrajudicial knowledge from the issue of whether to award the sanctions. Judge Russell recused herself because she did not want to decide the motion to alter or amend the sanctions award. She unequivocally testified that she fairly and impartially decided the motion to award sanctions. She also testified that she did not harbor any ill will toward Duree.

We have employed a two-part test in deciding whether to vacate a judgment because of a judge's failure to recuse: (1) Was the judge required to recuse himself or herself under the Code of Judicial Conduct, Rule 601A Canon 3E(1) (1998 Kan. Ct. R. Annot. 455) before

making the decision at issue; and (2) if so, was there actual bias or prejudice that warrants setting the decision aside? See *State v. Logan*, 236 Kan. 79, 86, 689 P.2d 778 (1984).

A judge has a duty to recuse when impartiality might reasonably be questioned. *Logan*, 236 Kan. at 86. Applying the *Logan* standard here, Judge Sheppard found that a reasonable person would believe, based on the testimony of Judge Russell, that there was no influence or bias on her part.

Duree has had an independent review of his claims. Judge Sheppard conducted a full evidentiary hearing to learn whether Judge Russell should have recused herself earlier. The hearing afforded Judge Sheppard an opportunity to measure Judge Russell's demeanor, the quality of her memory, and her credibility. Judge Sheppard found that there was bad timing as to the Gerstle conversation but did not conclude that she had acted in anything but an impartial manner.

Duree was afforded notice and a hearing at every state of the process. He presented witnesses and was even allowed to testify in a narrative form at the hearing on sanctions. Judge Russell testified that she made her decision on admission revocation and monetary sanctions without considering the Gerstle conversation. Furthermore, Gerstle made positive statements about Duree, saying, "Duree is a great guy. He's really a nice guy." We find Judge Sheppard did not abuse his discretion in denying Duree's motion to alter or amend.

The Sanctions

We next consider whether there was substantial competent evidence to support Judge Russell's decision imposing a monetary sanction under K.S.A. 60-2007, and revoking Duree's *pro hac vice* admission. See *In re Marriage of Stockham*, 23 Kan. App. 2d 197, Syl ¶ 1, 928 P.2d 104 (1996). The K.S.A. 60-2007 standard of review appears to have various descriptions from "each case must be carefully considered on its merits and no universal rule should be applied," *Rood v. Kansas City Power & Light Co.*, 243 Kan. 14, 23, 755 P.2d 502 (1988), to "abuse of discretion," *Summers v. Montgomery Elevator Co.*, 243 Kan. 393, 399, 757 P.2d 1255 (1988), to "substantial competent evidence," *Giblin v. Giblin*, 253 Kan. 240, 252, 854 P.2d 816 (1993). *Giblin* also holds that the court can determine de novo what the facts establish or if the K.S.A. 60-2007 requirement of a "reasonable basis in fact," to be decided on a case-by-case basis, has been met. 253 Kan. at 254.

Under K.S.A. 60-2007, sanctions were not a matter of discretion. (K.S.A. 60-2007 has been repealed; see L. 1997, ch. 173, § 38.) The Kansas Judicial Council comments to HB 2007 state:

> "The advisory committee recommends the repeal of 60-2007 in that it overlaps with, and contains somewhat different standards from, 60-211. K.S.A. 60-2007

> was adopted in 1982 and at that time there were no provisions in 60-211 for assessing costs for frivolous acts. Subsequent amendments to 60-211 appear to remove the need for 60-2007."

See 2 Gard's, Kansas C. Civ. Proc. 3d, Commentary § 60-2007 (1997).

K.S.A. 60-2007 directed that sanctions shall be imposed if the requirements of the statute were shown to be present:

> "(b) At the time of assessment of the costs . . . if the court finds that a party, in a pleading, motion or response thereto, has asserted a claim or defense, including setoffs and counterclaims . . . without a reasonable basis in fact and not in good faith, the court shall assess against the party as additional costs of the action, and allow to the other parties, reasonable attorneys fees and expenses incurred by the other parties as a result of such claim, defense or denial. An attorney may be held individually . . . liable . . . for such additional costs where the court finds that the

> attorney knowingly and not in good faith asserted such a claim, defense or denial or, having gained knowledge of its falsity, failed to inform the court promptly that such claim, defense or denial was without reasonable basis in fact."

Two separate requirements must be met before attorney fees and expenses may be assessed under K.S.A. 60-2007(b): (1) The claim asserted must be without a reasonable basis in fact; and (2) the claim was not asserted in good faith. *Gilbin*, 253 Kan. at 252.

A dismissal on summary judgment does not itself indicate that the claim was frivolous. *Rood*, 243 Kan. at 24. Every lawyer who loses on summary judgment should not be vulnerable to sanctions. Proof that Kessler and Banks' fifth amended counterclaim was without a reasonable basis in fact is found in Judge Russell's summary judgment opinion. Judge Russell first concluded that out of 267 statements of uncontroverted fact submitted by DAI, there was a good faith controversy concerning only four facts. None of the four were material to the fraud counterclaim. Further, Judge Russell found that there was *no evidence* to support Kessler and Banks' claims, much less the "clear and convincing evidence" that is required to prove a fraud claim. Judge Russell repeatedly cited gaps in the evidence.

For example:

"[T]here is *no evidence* that defendants' losses were caused by the fraud or misrepresentation of the plaintiff."

"There was *no way for Kessler and Banks to prove causation* because their own expert testified that "the books and records they maintained are so chaotic that no business decisions can be made from them."

"Kessler admitted in her deposition that she has *no proof* of the falsity of some of the defendants' alleged fraudulent statements."

"After five years of exhaustive discovery defendants still have *no proof* of the falsity of these statements. It is not just that they cannot sustain their burden of proving the falsity of these statements, *they have no proof whatsoever*."

The defendants argument "simply flies in the face of contract law."

"Kessler admitted that she had *no evidence* to support her claim...."

"[Kessler] has *no proof* that either of these beliefs on her part are true."

"Defendants have had ample time to conduct discovery and come forward with proof of plaintiffs' fraud and duplicity, but have not been able to do so." {Emphasis added.)

Judge Russell, in concluding, observed why Duree's theory that DAI duped Kessler and Banks into signing a franchise contract which was to set them up to fail defied common sense.

> "The initial franchise fee for a Subway shop is low - only $7,500. Common sense would indicate that the franchisor's principal hope for making money from the franchise agreement lies in the 8% royalty payments it is to receive from the gross weekly sales."

Judge Russell's findings show that the fraud claims in the fifth amended counterclaim were brought without a reasonable basis in fact. Her summary judgment decision was issued June 9, 1995, almost 1 year *before* the ex parte communication with Gerstle.

Good Faith

We conclude the record reflects substantial competent evidence that Duree neither asserted nor pursued the fraud claims in good faith. Duree knew the fraud counterclaim was problematic as early as 1992, when he orchestrated the preparation of the amended 1989 tax return. He directed Seiffert to prepare the amended return and used it to oppose DAI's motion for summary judgment.

DAI's motion for summary judgment was based, in part, on the fact that Kessler and Banks could not show any loss in their business. Duree used the 1989 amended tax return not only to attempt to

controvert facts but also to persuade Judge Russell that DAI's motion for summary judgment was frivolous. The Seiffert affidavit directly targets the problems with Kessler and Banks' case. Seiffert tried to justify Kessler and Banks' mismanagement and used the amended return to dispute DAI's uncontroverted fact that the franchise was profitable. Duree's response to the DAI summary judgment motion on behalf of Kessler and Banks admitted a few of the facts but attempted to deny most of them without any citation to where conflicting evidence might be found. Judge Russell was forced to carefully sort through Duree's deliberate "red herring" distracting responses and the record to decide what facts were genuinely in controversy. At the time Duree was arguing DAI should be sanctioned for filing the summary judgment motion, he had not complied with Rule 141(b). He denied uncontroverted facts on behalf of his clients without any basis in the record to support the denials.

Judge Russell found that Duree had attempted "to divert [her] attention from the facts of the case, to try to make [her] angry at plaintiff and plaintiff's attorneys." Such an attempt shows Duree's lack of good faith. At the hearing at which Duree was sanctioned $5,250, the 1989 amended tax return first became an issue. Duree had questioned the ethics of DAI's counsel in referencing the original 1989 return prepared at Kessler's request by H&R Block. DAI took strong exception. The sanctions hearing would probably not have taken place but for Duree's attempt to

divert Judge Russell's attention from the merits of the case by accusing DAI of impropriety. Duree's predicament is self induced.

Knowledge and Intent

Duree argues that to impose sanctions, findings that he acted intentionally, with actual knowledge that the amended return was false, are necessary. He asserts there was no evidence from which Judge Russell could infer that he had actual knowledge of the alleged falsity of the amended return. Duree confuses the legal standards for sanctions under K.S.A. 60-2007(b) with the MRPC. See Rule 226 (1998 Kan. Ct. R. Annot. 273). Judge Russell examined the MRPC in making her decision but explicitly noted that "'[t]he power to regulate the bar, including the power to discipline its members rests inherently and exclusively with [the Supreme Court].'" (quoting *State ex rel. Stephan v. Smith*, 242 Kan. 336, Syl. ¶ 12, 747 P.2d 816 [1987]). Judge Russell used the MRPC for guidance, but not as authority to sanction Duree.

Duree also observes there is no way for us to conclude that he had "actual knowledge of the alleged falsity of the Amended Return." He makes this argument holding an L.L.M. in Taxation from Washington University School of Law (St. Louis). Moreover, Duree continues to advance the notion that there is nothing wrong with the 1989 amended return. He has argued many things on appeal, but he has not admitted that the amended return was essentially a false

document. Instead, he points the finger in all directions, at his co-counsel, Robert L. Carter, at Judge Russell, at counsel for DAI, Edward Dunham, and even at his own clients. He implies that he was an unwitting participant in an unfortunate, but not illegal or unethical pursuit of fraud claims.

The 1989 amended tax return was evidence of Duree's misconduct. Judge Russell knew after ruling on the summary judgment motion that Kessler and Banks' fifth amended counterclaim was without a reasonable basis in fact. Duree's involvement in the preparation of the 1989 amended return showed Judge Russell that Duree understood the baseless nature of the claims. Judge Russell discovered that Duree had the amended return prepared to bolster Kessler and Banks' claim. It then became clear that Duree himself understood the shortcomings of his clients' case from the outset but tried to cover them up by fabricating evidence. The cover-up provided Duree had acted knowingly and not in good faith both in drafting the fraud counterclaim and in opposing DAI's motion for summary judgment.

The purpose of K.S.A. 60-2007 is to penalize willful misuses of the judicial process. *Smith v. Dunn*, 11 Kan. App. 2d 343, 348, 720 P.2d 1137 (1986). Judge Russell found that Duree tendered the 1989 amended return to the court as an accurate and reliable document. Judge Russell also found that the amended return was neither reliable nor correct in light of Kessler's own testimony. Kessler testified that she failed to

deposit more than half of the Subway shop's gross receipts. In spite of his knowledge of Kessler's creative personal financing and the existence of a reliable original 1989 return, Duree directed the preparation of the amended return. These factual findings supported Judge Russell's legal conclusion that Duree asserted the fifth amended counterclaim without any good faith basis in fact or law. Her conclusion is supported by substantial competent evidence and is sufficient to award sanctions under K.S.A. 60-2007. District courts are encouraged to impose sanctions under K.S.A. 60-2007 to protect litigants from harassment to clear cases of violation of professional duty. *Rood*, 243 Kan. at 22.

Our review of the voluminous record supports Judge Russell's conclusions. (The record consists of 55 volumes. The 32 volumes of pleadings spans 7,274 pages. The 23 volumes of transcripts exceeds 1,500 pages.) She concluded in her memorandum opinion on sanctions:

> "It is the amended 1989 tax return that is at the heart of the motions at hand. Mr. Dunham charges that Mr. Duree manufactured the amended 1989 tax returns to serve as a basis for the defendants' fraud claim. After carefully considering the evidence, the court has reluctantly concluded that Mr. Dunham is correct."
>
> ....

> "The inescapable conclusion from these facts is that Mr. Duree deliberately caused to be prepared a false tax return for use in this litigation."

Duree does not challenge the reasonableness of the fees, the hourly rates, the amount of work performed, or the expenses claimed. Duree's position is that the monetary sanction is not proper. The $408,445.25 includes, among other items, attorney fees: Wiggin & Dana (Dunham's firm), $272,263.51, and Turner & Boisseau (Kansas counsel), $74,077.03. Expenses included: accountant Arthur Anderson, $35,141; video taping, $3,416.20; and court reporters, $22,276.14.

We observe that all litigation must be orchestrated on a common dominant theme, the purpose of truth. Candor and credibility, are the twin professional characteristics that mark a true officer of the court.

In conclusion, the Friday afternoon chambers visit between two old friends requires comment. As Judge Sheppard noted:

> "The timing of the discussion is important . . . . Had it occurred the day after filing of the memorandum decision, there would have been no real reason or opportunity to complain about the substance of the ruling. As it is, the timing was absolutely terrible

> in terms of eroding confidence in the independent exercise of judgment on the part of Judge Russell."

Duree was Kessler and Banks' lead counsel in the civil case. Gerstle had been council for Kessler on her forgery charges, her plea sentencing, and her probation revocation hearing for allegedly failing to submit to a drug screen. Duree paid part of Gerstle's fee for representing Kessler on the forgery charges. Gerstle and Duree discussed Gerstle's criminal representation of Kessler. The gist of the discussion, according to Gerstle, was that Duree wanted Kessler to have skilled criminal representation, because if she had a criminal record or particularly if she went to jail, it would be harder for Duree to successfully prosecute the civil action. Gerstle told Judge Russell, "Mr. Duree is a great guy. He's a really nice guy. He paid my fees to represent Nancy Kessler."

Judge Russell's candor in informing counsel of her ex parte conversation with Gerstle is commended. However, the ex parte conversation was clearly inappropriate. See Rule 601A Canons 1, 2A, and 3B(7) (1998 Kan. Ct. R. Annot. 449, 451-52). Gerstle's professional curiosity and persistent questioning of Judge Russell as she sat behind her word processor was also clearly inappropriate. See MRPC Preamble: A Lawyer's Responsibilities, Scope and 3.5(c) (1998 Kan. Ct. R. Annot. 274-78, 360).

Affirmed.